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The Changing Landscape for Canadian Financial Services

New forces, new competitors, new choices

by
McKinsey & Company

September 1998

Research Paper Prepared for the Task Force on the Future
of the Canadian Financial Services Sector



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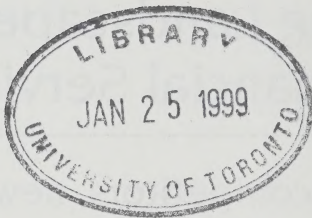
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The views expressed in these research papers
are those of the authors and do not necessarily reflect
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Preface

The financial services industry in Canada – and indeed around the globe – is in a state of flux. With the breaking down of traditional industry, regulatory, and geographic barriers, Canada's financial services* institutions and its government regulators needed to determine the best course of action that will ensure Canada's competitiveness in this industry that is of such critical importance to both Canadians and the overall Canadian economy.

Against this background, McKinsey & Company has gathered the insights and opinions of industry, business, and government leaders and assessed the facts on the global financial services industry, the forces affecting it, and the implications for Canada's institutions and consumers. This report is the culmination of that work.

* The scope of this effort focused on personal financial services (PFS) – which includes retail banks, trust companies, credit unions, caisses populaires, and retail asset management – life insurance and wholesale banking. P&C insurance and institutional money management were excluded from this review.

The McKinsey team responsible for the research, development, and writing of this report comprised Nancy Blair, an associate in the Toronto office; John Hall, a senior engagement manager in the Toronto office; Peter Simon, a senior engagement manager in the Toronto office; and Greg Wilson, a partner in the Washington, D.C. office. Business analysts John Kelleher and Terry Nopper and associates Aryn Kassim-Lakha and Jiri Maly also of the Toronto office provided analytical support for this report. Patricia Miller, a senior information specialist, managed all information and research demands for the study, and Andrea Nasello provided editorial assistance for the final report. Bernardin Mok provided invaluable administrative support to the project overall.

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1. Executive Summary

The approaching millennium brings a host of challenges and opportunities to Canada's financial institutions, their customers, and their regulators. The pace of change in the domestic and global financial services marketplaces is simply unprecedented. The evolving complexity of the businesses themselves, the emergence and growth of new competitors, and the array of choices open to customers are all having a tremendous impact on the Canadian financial services system. In this context, this report endeavours to accomplish three objectives:

- Develop an understanding of the forces shaping the global financial services landscape and the impact these forces are having on industry participants and stakeholders
- Examine the strategies leading institutions around the world have adopted to help them succeed in such a competitive and shifting environment
- Identify the paths regulators in other countries have followed as they try to balance their policy objectives within the realities of the evolving global marketplace.

In the chapters that follow, we seek to advance these objectives by examining Canada's financial services landscape, the forces reshaping the global financial services industry, and the impact these forces are having on Canadian players. We also assess Canadian financial institutions' competitiveness and some potential winning strategies, discuss how well Canadian customers are served, and explore the international regulatory responses to the forces of change.

Surveying Canada's financial services landscape. Canada is a comparatively small player on the world's financial services stage. This fact alone presents unique challenges for Canada's financial services industry in creating robust financing and trading opportunities for corporate customers, employment for Canadians throughout the industry, domestic opportunities for individual investors, and the acquisition currency for institutions seeking to grow beyond our national borders. Notwithstanding Canada's small size, there are no fewer than 3,000 individual institutions – encompassing banks, life insurers, finance companies, credit unions, asset managers, and investment dealers – seeking to gain a share of the country's \$2 trillion¹ in domestic financial assets and a slice of its \$19 billion in financial services profits. Despite the number of participants, Canada's six largest Schedule I banks and six largest insurers captured almost 50 percent of the country's financial services profits in 1997.

Examining the forces reshaping the industry. There are a set of forces of change around the world and in Canada that are shaping not only what share of the profit pool Canada's individual institutions will receive but whether they will be participants. This report explores a number of these forces, including: (1) rapid advances in technology and computing power that have enabled a variety of new delivery mechanisms and a new class of competitors; (2) increasingly sophisticated and demanding customers with new preferences that raise service hurdles and shorten product life cycles; (3) rapid and wide-ranging regulatory reform that is both a reaction to

¹ All amounts are in Canadian dollars unless specifically noted otherwise.

the other forces and a dynamic agent of change in its own right; and (4) globalization, which has taken many financial services – both wholesale and retail – beyond the realm of domestic competition and onto a global playing field where international financial services giants (e.g., ING, Merrill Lynch, Citibank) have redefined both the competitive and the regulatory landscapes and expanded the choices available to financial services customers.

Assessing the impact of these forces of change. Beyond the obvious creation of new forms of competition, these forces have changed the nature of the financial services industry profoundly over the past 5 to 10 years and promise to do so again over the next 5 to 10 years. Already we have seen banks being bypassed as the traditional providers of credit and savings products in favour of securities (tradable investments and obligations that are not held by an intermediary) – an impact referred to as disintermediation. Traditional, comprehensive service providers, like banks, have seen large parts of their businesses contested by specialized competitors as many customers willingly unbundle their financial services needs in search of the best prices and performance. Some new players do not even provide financial products or services per se, but rather serve as information channels between customers and a variety of financial services providers – in a sense, becoming a new type of intermediary. Traditional service providers (e.g., banks, life insurers, fund managers) are increasingly at risk of becoming commodity manufacturers of new information gateways that help customers navigate the dizzying array of product and provider choices.

These forces have also contributed to the unprecedented numbers of intra-industry consolidations and acquisitions across previously protected industry and geographic boundaries. Institutions have found it easier to grow and meet stock market expectations through these external means rather than through slower, organic growth. These new, large, multiline, multichannel players are facing increasing complexities and are consequently forced to spend staggering amounts on technology to manage and maintain the information flows and to acquire and serve ever-more demanding customer segments. Citibank alone spent an estimated US \$2 billion in 1997 on its information technology requirements (operating expenses and R&D).

Furthermore, increasing costs and falling profit margins in many traditional products (e.g., corporate loans, securities trading) have increased performance pressure on individual institutions despite an overall rise in financial services revenues and profits.

Analyzing Canadian players' competitiveness and potential winning strategies. The ability of Canada's financial institutions to be buoyed by these forces of change and to capture the many opportunities available will rest with their competitiveness – not only in their home markets but abroad as well. Our analysis and observations suggest that Canada's financial institutions – particularly the banks and life insurers – have their work cut out for them. For example, while Canadian banks enjoy relatively strong, domestic franchises and have recently made progress on their productivity, they are now competing with larger and better performing players in lines of business that are no longer the sole purview of domestic competitors (e.g., domestic equity underwriting, credit cards, residential mortgages).

Going forward, there are several strategic paths Canada's institutions may follow to increase their competitive edge. Many of these strategies have already been proven successful by winners in other markets; however, some would require changes to Canada's current regulatory regime.

For example, high-performing banks like Lloyds TSB in the United Kingdom have proven that a domestic retail focus, managed with superior discipline, can create the most valuable bank in the world. Others, like First Union in the United States, have shown that interstate consolidation and a rapidly integrated common technology platform can create shareholder value and avoid the customer service problems that usually accompany such ventures.

Canada's wholesale banks are already operating in a near fully global marketplace and need to both increase their internal productivity as well as find viable product and market niches. They simply cannot go head to head with global giants such as Merrill Lynch and Goldman Sachs as they lack the skills and expertise to effectively compete in this market.

The coming months and years will also be a unique test for Canada's life insurance companies. The country's four largest mutual firms (those owned by their policyholders) will be navigating the forces of change in their various product markets concurrent with plans to shed their mutual status in favour of becoming publicly traded companies. Canada's asset management companies will be similarly tested. They have benefited enormously from the demographic changes that have contributed to consumers' dramatic shift from savings to investment products; however, these same consumers are now armed with superior information and new choices and are demanding greater asset diversification, more innovative products and services, and fee levels more in line with US providers.

Evaluating how well Canadians are served. The forces affecting the marketplace and the responses of Canada's institutions raise questions for all stakeholders – but perhaps more so for customers. Specifically, how will customers benefit from these changes, and how well-served have they been to date? Though answering the first question is fraught with conjecture, the second does yield to analysis despite the inherent subjectivity imbedded in the term “well-served.” Based on our examination, all of Canada's customer segments appear to be well-served by their financial providers. Despite notable exceptions highlighted by the media and consumer interest groups, the weight of evidence suggests that – compared with other developed countries – Canadian customers receive competitive prices, quality choices, and ease of access.

Examining international regulations. The globalization of the world's, and indeed Canada's, financial services markets has created a challenge for the world's regulators. How do they advance their national policy interests of maintaining orderly markets, ensuring safe and sound institutions, and protecting consumer interests when many of the relevant forces at work and the players involved operate beyond national borders? Like the institutions themselves, regulators can choose from a range of responses: competitive neutrality – letting the market decide – as the United Kingdom and the United States have done; active promotion of national and global champions, as the Dutch and Swiss have pursued; or a middle-of-the-road approach that balances open competition with deliberate support of sizable domestic winners.

Whichever path is chosen, the ultimate success of Canada's financial services sector rests with the leadership of both its institutions and its governing regulatory bodies to craft and accommodate the strategies needed to succeed and serve customers in the increasingly global and competitive financial services arena.

2. Surveying Canada's Financial Services Landscape

By any measure, Canada is a small player on the world's rapidly evolving financial stage. This simple and overriding fact underscores the performance pressures facing many of Canada's financial services institutions. It has a significant impact on the strategies they craft, on the customers they serve, and ultimately on the regulators charged with crafting sound public policy.

To fully appreciate the forces at work in the financial services industry – and their implications for Canadian players – we first need to gain a common understanding how Canada fits into the industry's landscape. In this chapter we survey:

- The size of Canada in the global landscape
- The structure of its players
- The products they offer
- Their performance
- How they compare with international players.

Canada's Comparatively Small Size

It is no surprise that Canada is a small player on the world financial stage given its relative size as measured by GDP and population (Exhibit 2 – 1). It represents only 2.4 percent of the world's equity market capitalization, down from 3.8 percent in 1982 (Exhibit 2 – 2). Although Canada's markets have grown impressively in the past 15 years, the rest of the world's markets have grown even faster. As a result, Canada's importance as a financial market centre and its potential as a global base for its financial institutions have been diminished.

This small and diminishing presence in the capital markets could limit Canada's ability to capture opportunities in the evolving financial services industry. Having a large and robust presence creates financing and trading opportunities for corporate activities (Exhibit 2 – 3), employment for Canadians, domestic opportunities for individual investors, and acquisition currency for institutions seeking to expand their reach beyond Canadian borders.

Another relevant comparison is the size of the institutions themselves. At the end of 1997, Canada's six largest banks had a combined market value of US \$66 billion (Exhibit 2 – 4). This is approximately one-quarter the size of the six largest banks in the United States or the United Kingdom – but comparable to the five largest in Australia. A similar picture emerges for

Canada's life insurance sector. The implied value² of Canada's six largest life insurers is less than a quarter that of those in either the United States or the United Kingdom.³

Cross-country comparisons of total domestic financial services assets reveal that total asset size approximately mirrors country size and that banks hold the largest share of total domestic assets in Canada, the United Kingdom, and Australia – approximately 40 percent (Exhibit 2 – 5). Banks in the United States, on the other hand, hold a significantly lower proportion – 18 percent. Other sector sizes compare reasonably across countries, except for the share of assets held by mutual fund companies. The mutual fund business in the United States with its assets under management exceeding US \$4 trillion, towers Canada's by a factor of 15. This suggests more than simply population differentials are at work in this sector.

Given recent trends, the comparative size of each sector is beginning to change. For example, Canada's banks are growing considerably slower in value (although recent proposed mergers, if approved, will reverse this trend) than their counterparts in the United States and the United Kingdom (Exhibit 2 – 6). There, banks have grown through mergers and acquisitions as well as through the performance improvements of large providers such as Lloyds TSB. Canada's asset managers have gathered new assets at a faster rate than the United States despite the latter's higher market appreciation. Canada's life insurers, spurred by significant international growth, have also slightly outpaced the growth of their US counterparts (Exhibit 2 – 7).

Perhaps the best indication of Canada's comparatively small size in the financial services marketplace is its share of the world's profits in personal financial services (PFS).⁴ This measure not only displays the relative size of Canada's PFS and life insurance activities around the world, it also identifies the practical limits for domestic institutions competing in the Canadian market. In 1997, Canada represented US \$11 billion in PFS and insurance profits – just 2.9 percent of those earned around the world (Exhibit 2 – 8).

Canada's Players

While Canada may be a comparatively small player on the world financial stage, its service providers are varied and numerous. They extend well beyond banks, life insurers, and money managers. In fact, in 1997 Canada had over 3,000 individual institutions providing financial services and holding or managing nearly \$3 trillion in foreign and domestic assets (Exhibit 2 – 9) – with more than \$2 trillion in domestic assets alone. Credit unions and caisses are by far the most numerous. There are 2,434 of them, and they hold \$107 billion in assets. However, the banking sector, which comprises 53 Schedule I and II providers, is the largest in terms of financial assets held – with \$1.2 trillion or 46 percent of the total financial service industry assets in 1997 and 38 percent of the domestic financial service industry assets (Exhibit 2 – 10).

² Implied value for non-public companies is defined as the average price earnings multiple of stock insurance companies multiplied by the earnings of mutual companies.

³ Concentration as a percentage of GDP between the life insurance and banking sectors is similar.

⁴ The profits earned from providing individuals and small businesses with banking and asset management products and services.

Banks

Canada's banking industry is concentrated. Schedule I banks (the six largest institutions plus Canadian Western Bank and Laurentian Bank) control 86 percent of the \$776 billion in total domestic bank sector assets (Exhibit 2 – 11). Schedule II banks, which are predominantly foreign owned, are a highly fragmented group. No one institution exceeds a 3.1 percent share of domestic assets and, all in all, a total of 46 institutions share the remaining 12 percent of the total domestic assets (Exhibit 2 – 12). However, when taken in aggregate, this marginal share understates the importance of these institutions. Many of the Schedule II banks target specific communities or clients, achieving a higher representation within their target groups. For example, the Hongkong Bank of Canada, the largest of the Schedule II banks, is well-positioned within the substantial Chinese communities in Ontario and British Columbia. It enjoys a stronger presence and greater success in these markets than its national market share of 3.1 percent would suggest.

Life insurers

Like the banking sector, Canada's life insurance sector is also concentrated, but to a lesser degree. Over 70 percent of the sector's domestic assets are controlled by the top six life insurers (Exhibit 2 – 13). This level of concentration has come about only recently, due in part to the 22 percent pro forma share that Great West Life now holds since acquiring London Life in August 1997.

The ownership of the life insurance sector is particularly interesting – and it too is in the throes of change. At the moment, approximately 25 percent of the industry's assets are controlled by stock companies – those whose shares are listed on Canada's stock exchanges. As of December 1997, Great West Life, London Life, and Crown Life were Canada's major stock companies. The balance of the sector assets are controlled by "mutual" companies – life insurers owned by their policyholders. In the last month of 1997 and the first months of 1998, Manulife, The Mutual Group (which owns Mutual Life), Sun Life, and Canada Life all announced their intentions to become stock companies. If and when they do, the Canadian life insurance landscape could change significantly either through further acquisitions and mergers among the life insurers themselves or through acquisitions by larger financial services groups, including banks if allowed after regulatory review.

Credit unions and trusts

The credit unions and trusts have traditionally played important and unique roles in the Canadian financial services landscape. They are the most numerous of the non-bank financial institutions, although they control only 8 percent of the country's domestic financial industry assets (Exhibit 2 – 14).

A single institution or federation of institutions dominates each of the trust and credit union sectors. The cooperative sector's 5 percent share of financial assets is dominated by the Mouvement des Caisses Desjardins, a cooperatively-owned financial conglomerate based in Québec with affiliates in New Brunswick, Ontario, and Manitoba. The Caisse holds 54 percent of

total credit union assets and represents over 1,400 credit unions serving over 5.4 million members. Credit unions also play an important role in British Columbia and Saskatchewan. While not as prominent as caisses in Québec, credit unions in these two provinces have market shares in most personal financial services products that exceed the Canadian market share of cooperatives. The BC Central Credit Union represents over 90 independent institutions serving more than 1.4 million members. The non-bank-owned trust companies – a shrinking group – are dominated by CT Financial, which markets its range of PFS products under the Canada Trust banner.

The ownership of credit unions has been an important factor in determining their roles in the industry. Owned by their members, credit unions have faced less of a profit imperative than shareholder-owned banks. As a result, they have been able to assess credit risks at a more local level and provide more tailored services than the banks and trusts traditionally could or would. For years, trust companies were limited in the types of products they were allowed to offer. With the removal of these traditional pillars and the change in marketplace dynamics, trust companies have repositioned themselves. Today, one approach trust companies take is to provide more personalized advice – particularly for investments – than traditional bank channels.

Asset managers

The asset management sector – a business in which invested assets of individuals or pools of pension assets are actively managed – is characterized by both institutional and retail segments, which split the sector approximately 60/40 (Exhibit 2 – 15).

The institutional segment is relatively fragmented despite the presence of a leading player – the Caisse de dépôt et placement du Québec. The Caisse manages the pension assets for Québec's public-sector employees and holds an 8 percent share of all such assets in Canada. Over 125 asset managers vie for the remaining 92 percent.

The story is similar on the retail side. There are a few large players – both bank-owned and independent – with market shares ranging from 5 to 11 percent that account for half the industry's total assets. Approximately 60 players, both domestic and foreign-owned, compete for the remaining half.

The real story in asset management is not its absolute size or relative concentration but its spectacular growth over the past 5 years. Fueled by a mix of changing demographics, rising markets, and investor demand for returns that exceed those of traditional deposits and guaranteed investments, retail and institutional assets under management have grown at a compound annual rate of 33 and 20 percent, respectively, since 1992. Approximately 40 percent of this growth is attributable to market appreciation.

Investment dealers

Since 1987, Canada's banks have been allowed either to buy independent investment dealers or to expand on their own into capital raising, market making, brokerage, and other securities activities. The past 10 years have seen banks acquire Canada's largest investment dealers. As a

result, the six largest banks now hold a 70 percent share in businesses that were traditionally the domain of investment dealers (Exhibit 2 – 16). Of the independent investment dealers that remain, Midland Walwyn is the largest.

Given the increasing number of mergers and acquisitions in Canadian financial services, this sector will likely continue to experience dramatic changes in the coming months and years (Exhibit 2 – 17).

The Products They Offer

Canada's financial institutions provide a wide variety of products to Canadian customers. These products can be classified into three broad categories: personal financial services (PFS), business banking, and life insurance. Furthermore, many providers of, and alternatives to, all major product categories also compete in these sectors (Exhibit 2 – 18).

PFS product lines in particular enjoy the fullest participation of alternative institutions providing access to payments, customer credit, and asset accumulation products. For example, access to the payments system can be gained directly by Schedule I and II banks, trusts, and credit unions. Retail fund managers and life insurance companies, however, can only gain access through deposit-taking subsidiaries such as their banks or trusts. Business banking and life insurance product lines are also offered across the full spectrum of institutions, although not to the same degree as PFS.

McKinsey analysis estimates that Canadian institutions compete for a total financial services profit pool of \$19 billion (exhibits 2 – 19, 2 – 20, 2 – 21,⁵ 2 – 22). The majority of these profits – 69 percent, or \$13.0 billion – are generated by PFS products. Business banking products and services account for 24 percent of the total financial services profit pool, while life insurance accounts for 7 percent.

Schedule I banks earn less than half (approximately 46 percent) of the total PFS and insurance profit pool in Canada. This figure may seem counterintuitive, given the current banking concentration levels (i.e., greater than 50 percent) in earning assets such as mortgages, customer loans, and credit cards – PFS staples that generated approximately \$4.8 billion in pretax profits in 1997 (exhibits 2 – 23, 2 – 24). However, the largest banks hold a smaller share (approximately 23 percent) of the rapidly growing and highly profitable retail mutual fund business (exhibits 2 – 25, 2 – 26). In fact, the majority of retail assets under management are controlled by independent providers⁶, such as Trimark and Investors Group – a rarity in the Canadian financial services market.

Conversely, if pensions are excluded, banks capture the majority of *business banking profits*. Banks hold the leading market share in loans and they own the largest Canadian investment

⁵ For the purpose of comparison to other countries we have included life insurance profits of \$1.4 billion in the PFS profit pool. For the Canadian domestic sector we include this sum in the life insurance segment.

⁶ That is non-bank- and non-insurance-company-owned.

dealers (Exhibit 2 – 27). In 1997, Schedule I banks earned almost 60 percent of Canada's \$3.5 billion business banking profit (before pensions). If we include pensions, however, the banks' share drops to less than half – 44 percent of business banking profits.

In *life insurance*, the banks' share of the profit pool is small. Independent life insurers dominate this segment; however, their recent growth has stemmed from their PFS businesses, such as variable annuities and other investment-related products, not from life insurance.

Canadian Financial Institutions' Performance

If we are to gain a true picture of how Canada's financial institutions are performing, we have to look at them from several different perspectives (Exhibit 2 – 28). In this section, we examine how well they:

- Create shareholder value
- Provide employment opportunities
- Contribute to Canada's overall well-being
- Serve their customers.⁷

Creating shareholder value

Perhaps the easiest way to gauge performance is to look at it through the eyes of shareholders. Typically, shareholders are primarily concerned with two things: the potential for growth in the value of their investment and the financial performance/quality of earnings underpinning this potential.

Banks, life insurers, and retail mutual fund companies represent the great majority of the industry's revenues (78 percent) and profits (71 percent). Each has grown its business since 1992 (Exhibit 2 – 29). The six largest banks have succeeded in turning this growth into an annualized average return to shareholders of 29 percent in the past 5 years. These returns are high in comparison to other industries, such as manufacturing and mining, but they have been far outpaced by the 41 percent cumulative average returns realized over the same period by the four largest publicly traded retail mutual fund companies (Exhibit 2 – 30). The 10-year track record in shareholder growth sharply underscores this point (Exhibit 2 – 31): a dollar invested in bank stocks 10 years ago would be worth \$5.70 at the end of 1997; that same dollar invested in a retail mutual fund company would be worth \$18.67 – a cumulative difference of over 320 percent.

It is difficult to accurately measure the entire life insurance sector's returns because only three companies – Great West Life, London Life, and Crown Life – remained publicly held institutions during the same 5-year period. That said, it is unlikely that Canada's life insurers would have

⁷ How well Canadians are served is analyzed in greater depth in Chapter 6.

performed as well as the banks and mutual fund companies. Despite a 10-year growth in their retained surplus⁸ of 12 percent, life insurers only generated an average return of 8.8 percent on this surplus (exhibits 2 – 32, 2 – 33). By comparison, the banks earned 12 percent on their book equity during the same period, the top retail mutual fund companies 22.6 percent.

Also notable is that the six largest Schedule I banks have steadily enhanced their equity returns – from a low of 4.5 percent in 1987 to their current level of 17.1 percent – despite falling interest margins and stubbornly high costs. The banks' return on equity (ROE) can be disaggregated into revenue, expenses, and capital and analyzed over time to determine the impact of offsetting trends in individual profitability drivers (Exhibit 2 – 34). Despite having two of three critical drivers of this equation working against them, the banks were still able to increase returns. They did so by steadily increasing their non-interest income – both in absolute amounts and as a portion of their total revenues (e.g., underwriting and advisory fees, service fees, trading gains) (Exhibit 2 – 35).

Overall, shareholder investments in Canada's financial services industry have paid off handsomely. A dollar invested in the TSE's Financial Services Index 5 years ago would be worth \$3.84 as of December 31, 1997, a compound annual return of nearly 31 percent. That same dollar invested in the TSE 300, the broadest measure of corporate wealth creation in Canada, would only be worth \$2.23 – a 17 percent compound return. In fact, since 1992, the Financial Services Index has consistently outperformed all of the major indices except mutual fund managers (Exhibit 2 – 36).

Looking ahead, it is the prospect of *future* financial performance – both absolute profits generated and the rate of their growth – that will drive continued growth in an institution's share price. Increasingly, investors will consider both *realized* and *expected* financial performance trends in evaluating a company's future prospects. Analyzing the portion of a company's share price that can be attributed to current earnings momentum⁹ against the portion attributed to expected earnings growth above this level, reveals those institutions with the greatest potential for future value creation. For example, investors appear to have built significant growth expectations into their valuations of market innovators like Newcourt Credit and strong performers like the mutual fund companies. Investors are speculating that these companies will have more growth opportunities than their current earnings imply. Conversely, the market seems to be suggesting that the banks are fully valued, based on their current earnings trajectories, and only nominal growth premiums have been applied to their stocks (Exhibit 2 – 37).

Providing employment opportunities

With over half a million people employed in the financial services industry in Canada, employees are significant stakeholders in its future success. The most relevant performance criteria for Canadians employed in this industry are the number, stability, and quality of jobs.

⁸ The rate at which life insurers reinvest their profits in the business to fund future growth.

⁹ The discounted present value of an earnings stream projected at the company's 10-year historical earnings growth.

Despite the importance of this industry to the Canadian economy and the absolute size of Canadian financial services companies in our comparatively small domestic market, overall employment growth has not kept pace with improved financial performance. Total industry employment has held fairly constant since 1987, with just 0.2 percent growth or a net of 8,000 new jobs (Exhibit 2 – 38). Sector-by-sector trends can be misleading because the banks acquired a number of independent trusts during that period, which explains some of the 3.4 percent drop in the number of jobs in the trust sector. The flat growth rate in financial services employment can also be partially attributed to a general trend toward outsourcing activities, such as back-office processing, and improving productivity in areas such as credit application processes and in-branch transactions. As such, other countries have also seen declining employment levels in their finance sectors (Exhibit 2 – 39).

Despite this stagnant growth rate, employment in the industry has proved much more stable than in the manufacturing and mining industries and roughly equal to the aggregate level of industrial employment (Exhibit 2 – 40).

The true quality of these jobs is a difficult and ultimately subjective assessment. However, if we focus on both the absolute level and the trend of job compensation, financial services jobs are relatively attractive and becoming increasingly so. Weekly earnings for the entire financial services industry averaged \$785 per week per employee, second only to the mining and quarrying industry and 43 percent higher than other service industries. Furthermore, wage increases for the past 10 years in financial services have outpaced those in manufacturing and the aggregate of industrials, with the largest increases captured by employees in credit unions (Exhibit 2 – 41).

Contributing to Canada's overall well-being

A well functioning financial services sector is vital to the economic well-being of a country. By carrying out its essential function of capital allocation, risk protection, and transaction facilitation, it contributes to the overall economic growth and job creation of the nation.

Although we have not extensively reviewed the contributions that Canada's financial institutions make to the country's overall well-being, beyond these critical contributions, two direct benefits are readily obvious: the taxes they pay and their substantial corporate philanthropy.

In 1996, the total taxes (income, capital, property sales) paid by the financial services industry totalled \$8.4 billion – of which the top six banks paid \$4.9 billion or 58 percent (Exhibit 2 – 42). As the banks' share of overall financial services profits is 45 percent, it can be argued that they shoulder a disproportionate share of the tax burden, which is driven by surtaxes and capital taxes.

Banks contribute to the public good in other ways as well. They are substantial corporate philanthropists, donating more than \$78 million to numerous charities, arts, and human development agencies in 1997 alone (Exhibit 2 – 43). Other financial institutions, such as life insurers and credit unions, also contribute significantly to community causes. Manulife's strong support for the Heart and Stroke Foundation of Canada through its annual Ride for Heart fundraising campaign, the Co-operators' commitment to donate at least 1 percent of its pre-tax profit to charity each year, and Surrey MetroSavings' donation of \$100,000 to the Surrey

Memorial Hospital are just a few examples. In addition, there are the vast numbers of employees who devote countless hours volunteering in their communities.

Serving customers well

Customers are the ultimate arbiters of an institution's success – they either buy its products and services or they don't. Therefore, understanding how well customers' needs are being met – and the many alternatives they have to choose from – is essential to understanding the basis for competitiveness of Canada's financial institutions.¹⁰

Overall, in terms of pricing, quality, choice, and accessibility, Canadian small businesses receive only fair to slightly below fair service. The thorniest issue is access to credit given the absence of a more developed non-bank, sub-prime lending market (Exhibit 2 – 44).

The story is more positive on the retail side, where customers enjoy attractive overall pricing (despite their complaints about service fees), a reasonably large and expanding array of choices among providers, and world-class accessibility and convenience. Nonetheless, customers still have legitimate grumbles about the quality of service and the limited number of providers for some products (Exhibit 2 – 45).

How Canada Stacks up Internationally

In the remainder of this section, we compare in turn the financial performance and size of Canada's banks, life insurers, and asset managers to other international players.

Comparing banks

A *strategic control map*¹¹ developed by McKinsey measures the skills and ability of an institution to add value¹² for its shareholders against the resources it has at its disposal – that is, its equity size and strength. Institutions that have successfully created value for their shareholders by delivering high returns, increasing earnings, and providing a continuing stream of growth opportunities are rewarded in the marketplace with shares that trade at a multiple of their book value. The more successful an institution is at this, the greater its multiple.

In light of the global market for corporate ownership, these measures are becoming increasingly important to a bank's ability to determine its own fate. A bank that has a very high multiple, for example, can control its future to a certain degree through its *performance* – an acquisition by a larger, lower multiple bank would greatly dilute the would-be acquirer's shares. High multiple banks are not only strong defenders, they can also be powerful aggressors. NationsBank, the US regional player, is a good example (Exhibit 2 – 46). Its share multiple of over 5 times its book

¹⁰ Chapter 6 will explore the issue of how well-served Canadians are in greater detail.

¹¹ McKinsey & Company proprietary.

¹² Value is measured by a corporation's multiple of market value to book value.

value has allowed it to aggressively pursue acquisitions (e.g., Boatmen's Bancshares), gaining higher ownership in share exchanges than a lower multiple player would.

Banks can also exercise control through sheer *size*. A bank that is much larger than its potential suitors can defend itself relatively easily, simply because its suitors cannot finance the acquisition through share exchanges or other means. In this regard – at least for the time being – Bank Tokyo-Mitsubishi, HSBC, BankAmerica, and others with market values approaching or exceeding US \$50 billion appear to be able to control their destinies. Still, should their performance lag in the future, they could prove vulnerable.

When banks have both *size* and *performance*, they can completely control their strategic destinies. These players are rare. Take for example, Lloyds TSB, the UK-based retail banking powerhouse. Although it is not the largest in terms of its capital base, Lloyds has been so successful at consistently delivering earnings growth at equity returns in excess of 30 percent, its shares trade at more than 8 times its book value – making it the most valuable bank in the world. By comparison, no Canadian bank trades at a multiple above 3; on average, the six Schedule I banks trade at around 2.3 times book. Compounding this low trade value is the fact that Canada's banks are comparatively small. For example, Royal Bank, Canada's largest bank on a stand-alone basis, ranks 53rd globally by asset size.

By world standards, Canada's banks fall in among those that may find it difficult to control their destinies through either their size or their performance. In fact, it is only their recently improved financial performance that has enabled Canada's banks to approach value-creating returns¹³ (i.e., those above a benchmark return of approximately 13 to 15 percent)¹⁴ and improve their absolute market-to-book ratios to "laggard" levels (exhibits 2 – 47, 2 – 48).

Canada's banks are by no means alone in not hitting the benchmarks set by Citibank, NationsBank, and Lloyds TSB, among others (Exhibit 2 – 49). The low returns of Swiss and German banks have resulted in comparatively large but lower valued institutions and the poor returns realized by Japanese city banks and their continuously declining asset valuations have depressed their returns – and hence market multiples – to levels below those of both the European and the Canadian banks (Exhibit 2 – 50).

If Canada's banks are to control their own destiny without regulatory protection, they have two basic options: they will need to dramatically improve their performance with the resources they already have or substantially increase their size while maintaining or improving their performance. Cross-country comparisons suggest Canadian banks do have an opportunity to improve performance: while their profit margins have climbed close to UK and US levels in

¹³ Returns that adequately compensate investors for the level of risk (i.e., variability in expected returns) in a particular investment. Investments that exceed return expectations, create value, those that fall short destroy value.

¹⁴ Refer to *Valuation* by Copeland, Koller, and Murrin for a deeper discussion on the Capital Asset Pricing Model and what constitutes an appropriate benchmark or "hurdle" rate.

recent years (Exhibit 2 – 51), their efficiency lags that of the leading large player in each of the United States, Germany, and United Kingdom.¹⁵ (exhibits 2 – 52, 2 – 53).

While the preceding view highlights the value of size and performance to shareholders and the institutions, often the benefits to other stakeholders are embedded in the success of these two. For example, customers of well-performing, large institutions can benefit from unique product combinations and competitive pricing, while employees have more and varied opportunities with a robust and growing institution. The merits of size in financial institutions are explored further in Chapter 5.

Comparing life insurers

With the recently announced demutualization plans of Canada's largest life insurers, the discipline of capital markets will assume greater importance in this sector.

In terms of growth, Canada's life insurance companies have outpaced their US counterparts – but they have fallen short of the increase in assets generated by Swedish, UK, and the Japanese players (Exhibit 2 – 54). Moreover, their financial returns – like those of many of the world's largest players – simply have not been high enough to justify the investments made by their shareholders (in the case of stock companies) or policyholders (in the case of mutual companies) (Exhibit 2 – 55). That said, the profitability of Canada's top five life insurers has improved to the point where their net income to gross premiums lags only that of the top players in the United States and Sweden and outpaces the profitability gains made by Japanese, UK, Swiss, and German players (Exhibit 2 – 56).

Comparing asset managers

Though relatively new to the business, Canada has grown its pension and retail assets under management faster than any other developed market in the world (Exhibit 2 – 57). Canada is now the fifth largest such market. By the end of 1996, almost \$450 billion was invested either directly by individual Canadians in mutual funds or on their behalf in pension funds.

Canada's growth in this business – 15 percent per year for each of the past 5 years – is even more impressive when individual mutual fund growth is separated from pension funds. Over the past 10 years, direct investment by Canadians, coupled with strong market performance, has seen Canadian mutual fund assets grow at over 26 percent per year. By comparison, the US market – by far the largest and most developed – has grown at 19 percent per year over the same period (Exhibit 2 – 58). Aside from positive market performance, this success is due to the high level of mutual fund ownership by individual Canadians – second only to that in the United States (Exhibit 2 – 59).

Despite the overall growth in the Canadian marketplace, the size of individual Canadian asset management companies is still dwarfed by that of the largest players in Japan, Switzerland, and

¹⁵ The lower the efficiency ratio, the better the performance from a cost perspective.

the United States (Exhibit 2 – 60). While size alone does not drive better performance¹⁶ it *can* provide the scale needed to spread out research and management expenses and pass along the efficiencies to customers.

In sharp contrast to the majority of PFS-related business lines, banks (with a total share of just 25 percent) do not dominate the mutual fund business in Canada. Three of the four largest fund managers are independent firms, and non-bank-owned players have grown faster than their bank-owned counterparts (Exhibit 2 – 61).

* * *

As we have seen, Canada's comparatively small financial institutions face a huge challenge in achieving world-class performance and the scale to facilitate it. Moreover, the financial services landscape is changing and likely to change further. Like the forces that continually shift the earth's surface, profound forces of change are reshaping the financial services industry, not only in Canada but around the globe.

¹⁶ Underlying performance is driven by quality of asset gathering and, in turn, quality of the fund's management.

3. Examining the Forces Reshaping the Industry

The financial services industry is in the midst of massive change. Consolidation in wholesale financial services and, more recently, in personal financial services is changing the industry's structure, leaving only a few large players at the national level in many countries and elevating more players to the global level. At the same time, new non-traditional players, such as retailers and software firms, are emerging as aggressive competitors.

Examples of these changes abound. Global providers such as ING Barings, Citibank, Merrill Lynch, Deutsche Morgan Grenfell, and the Zurich Group are aggressively entering new markets and targeting new customers. For the first time in Japan's history, for instance, three US financial institutions dominated the trading business for several months. Announcements of large mergers and acquisitions – like First Union and Core States, Union Bank of Switzerland and Swiss Bank Corporation, and BancOne and First NDB Chicago Corp. – are not only common, but are now dwarfed by the proposed mergers of Travelers and Citicorp and NationsBank and BankAmerica.¹⁷

Canada's domestic financial services market is not immune to these structural changes. Already, we have seen foreign providers make significant inroads into Canada in some areas. In investment banking, for example, even though foreign competitors are not major players in Canada's domestic corporate equity market, four are among the top 10 underwriters of Canadian corporate debt and seven are among the top 10 underwriters of international equity and debt (Exhibit 3 – 1).

There are four major forces significantly reshaping the world's financial services industry:

- Technological advances in computing and communications
- Increasingly sophisticated and demanding customers
- Rapid and wide-ranging regulatory reform
- Globalization.

Technological Advances in Computing and Communications

A global revolution in computing and communications is spawning dramatic changes in the financial services industry. Declining computing costs coupled with rising computing power are enabling technological advances in the development and delivery of financial products and services. Lower costs and enhanced functionality are also increasing the use of technology among financial services providers and the customers they serve. Financial service providers with innovative cultures, and skilled employees, have the opportunity to fully reap the benefits of this technological revolution. Those service providers with skill gaps and a lack of innovation in their organization, on the other hand, may find it difficult to fully benefit from technology.

¹⁷ Includes announcements as of April 30, 1998.

No doubt, the power of computers will continue to escalate as the price continues to drop. In 1982, microprocessors with a computing capacity of one million instructions per second (i.e., one MIP) cost almost \$1,000 (Exhibit 3 – 2). Today, one MIP costs about \$1.30; within a decade, we estimate it will cost about \$0.001. Simultaneous advances in communications technology (e.g., fibre optics, compression technology) are enabling increasingly vast amounts of data to be transmitted at marginal costs. This explosion in the amount of bandwidth available to carry digital communications will, in turn, enhance the power of computers enormously. Together, these advances are continuously reducing the costs of business interactions – a key driver of industry and business line structure. At the national, industry, and company levels, business interactions account roughly for more than 50 percent of all labour costs.

As an interactive- and technology-intensive industry, technological advances have been particularly important to financial services. Such advancements are enabling financial institutions to serve their customers better, faster, and cheaper. Advanced data analysis software, for example, has allowed financial institutions to develop sophisticated, highly predictive database marketing programs. These have been implemented successfully by high performing credit card companies such as MBNA to target high-value customers more effectively in both their domestic and their foreign markets.

Technology has also enabled a variety of new delivery mechanisms that permit access anywhere, anytime to an increasing array of innovative financial services products. Electronic access to cash is now an everyday occurrence for most customers. Smart cards can be used for cash, debit, credit, and charge transactions, serving multiple functions and linking multiple customer accounts. Moreover, transferring funds, paying bills, and checking interest rates over the telephone or through a computer are readily available services at most banks. Electronic commerce is also booming, enabling customers to shop for a full range of financial and other products over the Internet. In the near future, electronic wallets will store our electronic cash and manage our transaction records.

Recognizing technology's benefits and ease of use, customers are increasingly embracing it. Over the past 10 years, the number of Canadian households with computers jumped from 10 to 35 percent (Exhibit 3 – 3). Customers are also linking into the Internet at a rapid pace. Canada currently ranks seventh in terms of Internet hosts per capita, and these services are growing each year (Exhibit 3 – 4). Some experts are even forecasting that personal computer and Internet penetration levels will equal that of current telephone penetration within the next 5 to 10 years.

Not surprisingly, customers' adoption of new technologies in the financial services industry has been particularly strong and is expected to continue. For example, in 1992, Canadians made 30.3 million automatic debit transactions.¹⁸ In 1997, this number grew to an immense 1,003.9 million (Exhibit 3 – 5). The adoption of telephone banking has also been strong. In 1995, telephone transactions accounted for 1 percent of retail transactions. By the end of this year, the share of telephone transactions is estimated to be 10 percent (Exhibit 3 – 6).

¹⁸ Defined as EFT/POS terminal transactions in Exhibit 3 – 5.

Increasingly Sophisticated and Demanding Customers

Shifting customer demographics are also having an impact on the financial services industry. As the majority of Canadians get older and achieve higher education levels (Exhibit 3 – 7), their tolerance for risk and their preferences for what and how they buy is changing.

Customers are becoming more involved, more knowledgeable, and more aware of financial product characteristics and provider choices. Their concerns about the potential loss of government- and employer-supported retirement programs, combined with lower inflation and lower returns on deposits, have led them to become more involved in their own investment planning and decisions. With this increasing sophistication, customers have also become more accepting of non-traditional providers and more comfortable with alternative delivery methods, including electronic channels (Exhibit 3 – 8).

With the rise of electronic channels, the personal bonds between customers and institutions are weakening presenting loyalty implications for financial services players. For example, Canadian customers are moving their assets from traditional, government-protected products like deposits to market-based securities and mutual funds. In 1992, 31 percent of financial assets were composed of basic deposits; by 1997, deposits' share of financial assets had fallen to 26 percent (Exhibit 3 – 9). Going forward, Canadians will likely take on more risk by shifting a greater share of their discretionary financial assets to long-term vehicles. Long-term assets as a percentage of total discretionary assets are forecasted to increase from 40 percent in 1996 to over 60 percent by 2006 (Exhibit 3 – 10).

Moreover, as customers become more involved in their own investment planning, they are demanding a broader range of products and services – including international offers – at more competitive prices and through more convenient channels. Long-term customer trends¹⁹ indicate that customer expectations are increasing rapidly across many dimensions, such as convenience, choice, sales experience, and price (Exhibit 3 – 11). In the past, customers were willing to trade off price for convenience; today, they demand better service, greater convenience, more information, and lower prices simultaneously. Furthermore, customers are placing increasing importance on brand-buying, perceiving the brand as an indicator of quality (Exhibits 3 – 12, 3 – 13).

Customer pressure has also caused product life cycles to shrink quickly in both wholesale and personal financial services. The days of the traditional savings and chequing accounts are gone; they have been replaced by sweep or cash management accounts that bundle customers' cash and savings needs into a more efficient and profitable package. Leading global wholesale banks, on average, develop a new product every week. Most leading investment banks have a dedicated group or groups of trained mathematicians and statisticians who continuously focus on developing product bundles for both issuers and investors.

¹⁹ As tracked by Yankelovich Monitor.

On the corporate front, chief financial officers are also becoming increasingly sophisticated. Combined with a much tighter performance management focus, this sophistication has led CFOs to demand not only low-cost financing wherever it is available but also world-class specialized financial advice. Most large corporations in Canada have their own trading desks and direct links to the marketplace enabling them to literally shop around the world or, at least, in the local offices of international players.

Financial services providers are responding to these demands by offering a broad range of choices, from specialized mutual funds and stock indices to derivative-based products like equity-linked bonds. Institutions serving the high-net-worth segment have also developed a wide range of exotic products for their customers, ranging from Bordeaux wine futures to antique car mutual funds to many varieties of distressed debt.

Rapid and Wide-ranging Reform

Regulators are becoming increasingly aware that sophisticated and demanding customers are looking beyond their national borders for investment and financing options. At the same time, the globalization of capital markets is forcing all markets toward a new global standard for both conducting business and supervising financial institutions.

All major markets are undergoing some form of financial reform, involving both traditional providers and non-traditional entrants. These reforms are, to some degree, a reaction to other forces. However, regulatory reform acts as a force on its own as well because it facilitates the emergence of truly global providers by breaking down the barriers between products and countries, it facilitates the emergence of truly global providers. Today, for example, pricing restrictions have been eliminated, geographic limitations and barriers to entry have fallen in most countries, and restrictions on the range of financial services businesses can offer are breaking down throughout most of Europe, North America, Australia, and Asia.²⁰

Europe, for example, is moving toward full financial and monetary union before the new century. In addition to having a common currency, European financial institutions will be able to operate in any part of the continent without restriction or regard to political boundaries. The United Kingdom has just overhauled its regulatory system completely to ensure London remains a dominant financial centre in the new union. The Bank of England has transferred its supervisory responsibility to a new, integrated financial service regulator – the Financial Services Authority. Regulators in the Netherlands, Switzerland, and Spain have helped their country's major financial institutions become stronger national and global players by using their discretionary powers and judgement to allow strong, potentially long-term winners to consolidate weaker players.

The United States is in the middle of its biggest restructuring and reform effort in recent history. After years of debate in Congress and slow action at the state level, the United States has finally moved to a system of full nationwide banking, much like Canada. While there are still thousands

²⁰ See Chapter 7 for more detail on regulatory change in other countries.

of banks in the United States, greater consolidation will occur with this elimination of artificial political barriers. Old barriers separating commercial and investment banking have also been eliminated through new rulings from the Federal Reserve. This action will allow new combinations of companies to serve both retail and wholesale customers with a wider array of banking and securities products. Moreover, any company today, passing the “fit and proper” test, can own a retail banking franchise license. The Travelers Group, Merrill Lynch, Fidelity Investments, GE Capital, Morgan Stanley Dean Witter Discover, State Farm Insurance, and many other financial services providers are acquiring retail banking licenses (through a federal savings bank charter) to serve their customers with new, attractive value propositions.

Australia has also just completed a review of its regulatory regime, especially as it relates to foreign competition and domestic mergers. The country’s 1997 Financial System Inquiry (the Wallis Commission) made a number of recommendations to remove Australia’s remaining restrictions on mergers; align ownership, acquisition, and competition rules with other industries; ease restrictions on corporate structures; and foreign ownership; open up access to the payments system; and align its system of regulation to encourage greater trade in financial services. These recommendations have either been implemented or are currently under review by the Australian government.

Reform efforts are under way in Asia as well. Some of these efforts are driven by crisis while others have arisen from unique opportunities. In Thailand, Korea, and Indonesia, economic crisis is driving basic market reform: failed banks are being closed, new risk management and accounting systems are being demanded, and greater competition and foreign entry are being facilitated to restore the health of their financial systems. In sharp contrast, Singapore is using its strong financial base to reform and restructure its entire regulatory system to secure its position as a leading financial centre in Asia.

Japan’s “Big Bang” represents a fundamental change and restructuring of its regulatory system. Before the year 2000, Japan, which historically has been one of the most closed and heavily regulated markets in the world, has committed to:

- Abolish restrictions on foreign management of pension funds
- Allow foreign financial institutions the same freedoms as Japanese institutions in terms of products, distribution channels, and clients
- Eliminate the separation between different financial service sectors (e.g., full-service providers will be allowed including wholesale, retail, and insurance).

Many of these country-specific reforms, as well as international reform efforts (e.g., the recent World Trade Organization (WTO) agreement in the financial services industry), are regulators’ attempts to respond to the forces of change. Paradoxically, as global players gain in skill, size, and strength, the ability of any single national regulator to fully supervise them will become increasingly limited. The flows of capital are simply too massive and powerful for domestic governments to apply their own standards successfully for any length of time to companies

beyond their own national boundaries. For instance, the volume of the top three markets²¹ daily foreign exchange trading activity²² has decreased the central banks' ability to intervene in the foreign exchange market to support their national currencies (Exhibit 3 – 14).

Globalization

Thirty years ago, less than half the countries in the world were considered “open.” Today, roughly 80 percent are open, and more are either opening voluntarily or being forced to do so by market forces (Exhibit 3 – 15). This greater openness, easier access, and lower friction in conducting business across national boundaries has evolved as outmoded regulatory, geographic, and market barriers to delivering products and services have disappeared. In turn, capital mobility and the development of a global marketplace have forced industries to become even more global.

The increase in capital mobility around the world has been fueled by developing countries' need for more and more capital to fund new projects and investments. The developed world has willingly filled this demand by supplying capital through the purchase of international bond and equity issues. These investments in emerging market countries have grown at a compound annual rate of 43 percent from 1992 to 1996. In the United States, 14 percent of institutional investors' international equity holdings originate from emerging markets.

In the global marketplace, industries are globalizing at different rates based on specific industry characteristics. Physical commodities have been the first to globalize.

In the financial services industry, wholesale and investment banking are globalizing quickly, as many of the products and services offered are already global in nature. In wholesale banking, for example, the bond market is now truly global – as evidenced by the convergence in bond pricing between major markets (Exhibit 3 – 16). The total net issue of debt securities is roughly US \$2.5 trillion and growing at a 17 percent CAGR. Of this amount, international issues account for \$540 billion, with Canada representing a 2 percent share (Exhibit 3 – 17). More than 50 percent of all Canadian corporate bonds are issued abroad today (9 percent CAGR), as are 20 percent of all Canadian government-issued bonds (13 percent CAGR, Exhibit 3 – 18).

Personal financial services, on the other hand, are primarily domestic but are moving toward globalization in certain product areas such as credit cards and asset management. Up until now, the delivery of personal financial services has required a local physical presence. If a provider wanted to enter a local PFS market, it had to either acquire a local provider or try to build its own operations from scratch. It has historically been hard to compete for local banking services as a non-national because the business has been such an “insider's game.” This picture is slowly changing, however, with new forms of electronic delivery and aggressive new PFS competitors seeing the world as their marketplace.

²¹ London, Tokyo, and New York.

²² Over 1.3 times larger than the Organization for Economic Cooperation and Development countries' foreign exchange reserves.

* * *

Clearly, we are entering a 5- to 10-year period during which the global financial services industry will be fundamentally reshaped. The ensuing changes will not always be predictable because of the dynamic nature of the forces influencing the industry. Technology will continue to drive change in computing and communications power and further enable the delivery of financial services in new and yet unimagined ways. Customers, both retail and wholesale, will become continuously more sophisticated, raising their demand levels to new heights. Financial reform will continue not only as a reaction to these forces but also as a dynamic force in its own right driving further change. The globalization of both providers and their products will also continue apace for the foreseeable future. Perhaps more important from a public policy perspective is the fact that these collective forces are now effectively beyond the ability of any government to control, as many countries around the world are learning.

4. Assessing the Impact of these Forces of Change

Technological advances, increasing customer sophistication, regulatory reforms, and globalization are having a profound impact on all industries – including financial institutions in Canada and around the world. These forces, presenting both opportunities and threats, are influencing the industry's structure, the actions and responses of regulators, and the conduct and performance of financial services providers – particularly banks, life insurance companies, asset managers, and credit unions.

Impact on Canadian Banks

The forces of change in the global financial services marketplace are significantly changing the competitive dynamics of the Canadian financial services industry and affecting how Canadian banks view their competitors and serve their customers. With the constant surge of customer demands and technological advances, the impact of these forces may not always be predictable. That said, we have identified five major impacts on banks that we expect will continue to surface in the banking sector going forward:

- Disintermediation and securitization of financial assets
- Disaggregation and reaggregation of business systems
- Consolidation of financial institutions and convergence of business lines
- Greater complexity in serving customers
- Pressure on bank performance.

Disintermediation and securitization

Global forces are changing the traditional relationship banks have had with their customers. With new competitors constantly striving to deliver higher value products in new and different ways, customers have an increasing number of options for where and how to invest their money. More and more often, banks are being left out of this loop.

Disintermediation. Financial institutions serve as intermediaries between their different customer groups. For example – through intermediation – banks bring depositors, who want a safe place for their savings, together with borrowers, who need credit to buy a home or start a business.

Just as intermediation brings two parties with different financial interests together, disintermediation eliminates the traditional intermediaries between them. For example, with customers shifting away from traditional deposits due to their changing preferences, increasing sophistication, and ever-expanding array of available alternatives, intermediaries are becoming less of a necessity. Thus, customers are bypassing the intermediary and investing directly in capital markets through mutual funds, stocks, bonds, and other such instruments. Low inflation

and subsequent low deposit interest rates have fuelled the disintermediation trend. We would expect the shift away from bank deposits to slow down should interest rates begin to rise again.

Consequently, banks are increasingly being bypassed by consumers and businesses in favour of other financial institutions and direct providers. And, since deposits represent a large percentage of their PFS profits, banks will need to develop innovative new products and services to replace these shrinking assets.

Disintermediation is occurring in both wholesale and retail banking. In wholesale, businesses are becoming less and less reliant on bank loans as their major source of financing. As a percentage of all Canadian corporate debt, bank loans have fallen from 44 to 34 percent over the past 10 years. Corporate bond issues now represent a larger proportion of total corporate debt,²³ with a growth rate nearly four times that of traditional bank loans. As debt instruments that bring borrower and investor together, corporate bonds offer a more efficient form of financing, particularly for large businesses. They are attractive to sophisticated investors and benefit from standardized, observable credit ratings.

Similar trends can be observed in other markets such as the United States, where bank loans have shrunk from 27 to 21 percent of total corporate debt over the same period (Exhibit 4 – 1).

Advances in derivatives and risk management techniques, such as credit derivatives and credit portfolio management tools, have enabled more US borrowers to access capital markets directly, since risks can be managed much more effectively and precisely.

In PFS, the majority of retail assets are invested directly in capital market products rather than in traditional products offered by banks. The mix among deposits and other financial instruments varies between countries. In Canada, 58 percent of assets are invested in mutual funds, pensions, and securities. The shift away from bank deposits in the United States has been even more dramatic with 79 percent of assets currently invested in pensions, securities, and mutual funds (Exhibit 4 – 2).

Securitization. Recently, banks have proactively begun to engage in a form of disintermediation known as securitization – the process of converting loans, such as mortgages and credit card balances, into securities that are sold to investors with different risk-reward requirements (Appendix). Securitization benefits all stakeholders. For the intermediary, securitization helps move assets off the balance sheet, reducing the need to hold regulatory capital and permitting investment in other, potentially higher yielding, opportunities. For the borrower, securitization may eventually lead to lower cost loans and greater flexibility in product choice. For the trust or agent that provides liquidity enhancements and converts the assets into marketable securities, it provides alternative sources of revenue and profit. Finally, for the investor, securitization increases the variety of instruments available and offers a greater degree of liquidity than other investments.

²³ Has increased from 20 to 31 percent over the past 10 years.

Securitization is particularly well-developed in the United States: 41 percent of outstanding residential mortgages are securitized as are 60 percent of 1997's new residential mortgages.²⁴ Though securitization and the measurement and accounting for securitized assets are less developed in Canada, the popularity of securitization is growing. Based on estimates, outstanding asset and mortgage-backed securities reached \$27.3 billion in 1997, with a 5-year annualized growth rate of over 40 percent (the most common being residential mortgages, credit cards, and auto loans). This high growth rate of securitized assets is expected to continue as some banks securitized major portions of their credit card debt in 1997 (Exhibit 4 – 3).

As Canadian banks continue to securitize more of their assets, we should see improved performance in their returns on assets and equity.

Disaggregation and reaggregation of business systems

The second major impact on Canadian banks is the disaggregation and reaggregation of traditional businesses. Global forces are breaking up the business systems and reassembling them in ways that are enabling new entrants to serve bank customers often more effectively and efficiently than traditional providers. These new entrants are succeeding because they are designing their business systems around specific customer and market needs rather than around regulatory or geographic barriers.

Disaggregation. Like many others around the world, Canadian banks have historically provided products and services that spanned the entire PFS business system. This traditional view of PFS includes at least four distinct areas: product development, product servicing, distribution, and processing. Canadian banks typically compete in all four areas. These broadline financial institutions offer one-stop shopping, satisfying a myriad of customer segments with many products through multiple channels.

Today, however, financial institutions no longer have to provide products and services covering the whole business system. Both new and existing providers are emerging as product, service, customer, or distribution specialists and effectively selecting one or two parts of the business system in which to compete. In retail, for example, the mortgage business is no longer thought of as a single entity; it can be separated into three major areas: origination, funding and underwriting, and servicing. This means banks that underwrite mortgages can now securitize them to gain greater portfolio flexibility, enabling other companies to carry out the servicing over the life of the loan.

Product specialists have emerged in product lines such as mutual funds, mortgages, and credit cards – with large-scale monoline providers such as Fidelity, Countrywide, and MBNA gaining market share in the United States. The emergence of these non-bank specialists has had a profound impact on the US market. MBNA, for example, is now the second largest card issuer in the United States after Citibank. Its success can be attributed to its aggressive, tailored marketing to specific customer segments. Moreover, its focus on credit cards has enabled the company to

²⁴ *Federal Reserve Flow of Funds.*

develop superior skill sets in this area, which has resulted in lower delinquency rates than at full-service banks.

Foreign non-bank product specialists have yet to make significant inroads into the Canadian market. The threat to traditional players is real, however, since many foreign providers have recently announced plans to target Canada or have already opened Canadian locations. ING Direct, for example, has already started a successful assault on the Canadian savings account market, gaining over 40,000 customers in just over 7 months.

Other providers have emerged as distribution specialists – including Charles Schwab in mutual funds and TD Greenline and E*Trade in discount brokerage. Virgin Direct in the United Kingdom has used its brand value and distribution channels to enter financial services as have UK retailers like Tesco and Sainsburys. Virgin Direct aims to revolutionize and demystify financial services and claims to represent no fuss, honesty, innovation, and success. It has developed a strong brand value in its record and soft drink businesses that it hopes will carry-over to financial services. Two years after starting operations, Virgin had 160,000 customers.

In Canada, CIBC-Loblaws, TD-Maxi & Company,²⁵ and TD-Wal-Mart²⁶ are examples of new partnerships between banks and non-banks that are leveraging existing distribution networks. Technology has also enabled new distribution channels and new providers such as Mondex in smart cards and Citizens Bank in telephone, PC, and Internet banking. Citizens Bank, in particular, has developed a distinct advantage in remote distribution. Without a costly branch network to maintain, its cost structure is no doubt much lower than a traditional bank's.

Distribution specialists are also emerging from other industries. For example, in the United States, AT&T has leveraged its customer base and brand awareness to achieve 30 percent annual growth in its Universal Card – a product that combines the functions of a credit card with a calling card.

Reaggregation. While global forces are contributing to the disaggregation of the traditional business system, they are also enabling new entrants to reaggregate parts of the business system and create new types of intermediation. Electronic marketplaces developed by IT giants, Intuit and Microsoft, in the United States and i-money²⁷ in Canada bring together products and services from a variety of providers in one location. These new electronic intermediaries enable customers to find information quickly and easily, comparison shop, and purchase financial services without ever leaving the comfort of their home or office.

²⁵ Maxi & Company, a supermarket chain primarily in Québec, is owned by Provigo Inc.

²⁶ As of April 1997.

²⁷ A web-based “gateway” that connects consumers to a range of financial services providers according to customer-defined product and service parameters.

Consolidation and convergence

The consolidation of banks and other financial services institutions and the convergence of historically distinct lines of business are occurring at a rapid pace, creating large global institutions with both deep pockets and a global view of the marketplace.

Consolidation. Increasingly, financial institutions around the world are deciding to buy instead of build to increase revenues, decrease costs, acquire new managerial and operational skills, reduce industry overcapacity, enter new markets, gain access to valuable customers, enhance brand name value, and achieve economies of scale in key business lines (Exhibit 4 – 4).

Worldwide, both the number and the value of mergers and acquisitions have grown dramatically over the past 15 years (16.5 percent and 24.3 percent, respectively).

In the United States, for example, Morgan Stanley and Dean Witter Discover combined in 1995 to form one of the largest investment banks serving both retail and wholesale customers (1997 value of US \$10 billion). Now that all remaining geographic barriers to full nationwide banking and branching in the United States have been removed, institutions such as NationsBank, First Union, US Bancorp, and Wells Fargo have also become major consolidators. Travelers Group and Citicorp have raised the merger bar even higher with their proposed merger, which would create a financial services conglomerate with a combined customer base of 100 million and a market capitalization of US \$135 billion.

In Europe, Swiss Bank Corporation and Union Bank of Switzerland have combined to form United Bank of Switzerland – the second largest bank in terms of asset value in the world (1997 market value of US \$60 billion). Lloyds Bank and the TSB Group have also combined to form one of the highest performing retail banks in the world (1997 value of US \$69.9 billion). This accelerating merger activity is occurring across Europe in anticipation of a single Eurocurrency – with financial institutions rapidly consolidating within their own countries to strengthen their overall positions within the European Union (Exhibit 4 – 5).

This growth through acquisition coupled with internal growth by US and European banks, has altered the composition of the global top 30 banks as ranked by assets and market capitalization (Exhibit 4 – 6). US and European banks now compose a greater share of the top 30 than they did 10 years ago. On an asset basis, top 30 domination has shifted from Asian to European banks. In 1986, 62 percent of the top 30 bank assets were held by Asian banks; 10 years later, Asian banks helped only 41 percent. This decline in Asian bank assets is even more pronounced when we look at market capitalization. From 1992 to 1996, the share of market capitalization in the top 30 held by Asian banks fell from 70 to 44 percent. In 1997, Asia's share eroded further to 14 percent. Conversely, large US and European banks have increasingly infiltrated the top 30 ranking, holding 40 and 46 percent of the total top 30 market capitalization, respectively.

Investment banking is also concentrated. At the end of 1997, the global top 10 investment banks held 71 percent of the nearly US \$2 trillion worldwide securities market (Exhibit 4 – 7). No Canadian banks are among the top 10.

This flurry of merger and acquisition activity has raised some concerns about concentration within domestic markets and the impact of concentration on domestic customers. Determining the level of concentration in a market is difficult because of the wide variety of financial services products available today. One measure of concentration is the three-firm bank ratio, a commonly accepted comparison, that measures the share of domestic bank assets by the three largest institutions (Exhibit 4 – 8). Canada has a relatively concentrated market with a three-firm bank ratio of 53 percent. The Netherlands and Australia also have comparatively concentrated markets, with ratios of 57 and 59 percent, respectively. However, the pool of financial assets has expanded to include a wider range of products, such as mutual funds and annuities. This expanding array of financial products and services has been one of the determining factors in merger approvals in the Netherlands and Switzerland and in the recommendation by the Financial System Inquiry to allow large domestic mergers in Australia. When all financial institution assets are taken into consideration, the concentration levels fall significantly – in Canada, the three largest banks only hold 24 percent of all financial assets (Exhibit 4 – 9).

Convergence. As markets have opened up and the regulatory barriers between different types of businesses have come down, traditionally separate business lines have converged both in Canada and abroad. As a result of the 1986 amendment to the Ontario Securities Law allowing foreign ownership of Ontario security firms and the 1987 amendment to *The Bank Act*, Canada's four historic pillars of financial services – banking, brokerage, trusts, and insurance – have now largely converged into a single financial services marketplace (Exhibit 4 – 10). Financial institutions are now able to compete across all four pillars. A few large independent players still exist in trusts and securities but, for the most part, banks dominate these sectors. In life insurance and the newer asset management businesses, independent providers hold the majority share – with the banks holding a relatively small percentage.

In the United States, similar trends are occurring as old laws and rules are repealed or relaxed. There, banks are rapidly acquiring securities firms, and new combinations of insurance companies, brokerages, and banks are emerging (e.g., Travelers Group, USAA).²⁸ Much of this industry convergence has already occurred in Europe, with universal banks operating across the banking, investment, and insurance businesses.

Complexity in serving bank customers

Technology has not only enabled an array of new channels, products, and processes, it has also helped improve productivity and focus marketing efforts. However, despite these benefits, a technology paradox exists. While technology costs are declining and technological performance is improving, banks are spending more and more on technology (Exhibit 4 – 11). To support an increasing mix of retail, cross-border, and proprietary trading and risk management systems, as well as a number of processing businesses, the largest banks are spending anywhere from 15 to 21 percent of their non-interest expenses on information technology.

²⁸ By obtaining a federal savings bank (FSB) charter, any company can own a retail bank in the United States.

Banks are forced to spend these huge amounts on technology because of the increasing complexity of the environment. This complexity is driven primarily by customer demands. For large corporate clients, for example, banks must continually strive to devise new products and risk management techniques to serve their differing individual needs. Derivatives is an example of one such product that requires large investments in pricing techniques and risk management.

For retail customers, banks must now manage more products, through more channels, to a more diverse customer group. To deliver this increased convenience and access, banks have had to invest substantially in complex technology infrastructure. As a result, the number of transactions has risen sharply, with customers taking full advantage of the new channels and services. In the United States, transaction volumes have increased an average of 11 percent across all channels over the past 10 years, with telephone transactions alone increasing 40 percent. With this increased volume, transaction costs have also escalated (Exhibit 4 – 12).

Pressure on bank performance

Combined, the global forces at work and their subsequent impacts are placing great performance pressure on banks. Globalization, for example, has led to consolidation in the investment banking industry that, in turn, has led to decreasing spreads and declining ROEs. In the United States, spreads on mortgage-backed securities declined 57 percent annually from 1988 to 1996, while spreads in other asset-backed securities declined 24 percent over the same period. ROEs for the largest investment banks have also declined over the past 15 years (Exhibit 4 – 13). The cause and effect of this cycle have become increasingly hard to separate – global scale drives down pricing in low-value-added products, poor performers get sold to better performers, creating yet more reach and scale and hence continued pricing pressures.

Canadian wholesale markets are not immune to these global downward margin pressures. From 1993 to 1996, the bid/ask spread on Canadian government bonds declined from 4 basis points to 1, and the spread on Canadian corporate bonds declined from 20 points to 3. In the same period, the spread on new issue commissions was reduced by half (Exhibit 4 – 14).

These pressures have also contributed to a decline in banks' share of household financial assets in both Canada and the United States. This decline in banks' share of the retail market is primarily due to the shift away from traditional bank deposits: deposits in Canada declined from 31 percent of financial assets in 1992 to 26 percent in 1997. Mutual funds, on the other hand, are growing at an annual rate of 35 percent (Exhibit 4 – 15). In 1992, they represented only 5 percent of Canadian household financial assets, whereas they now account for 16 percent.

Traditional banks in Canada own half of all financial assets by channels;²⁹ however, their primary distribution network – the branch channel – is the slowest growing (2.7 percent compared to the average channel growth of 10 percent). By contrast, the full-service broker channel, which represented roughly 20 percent of all financial assets by channel in the same period, is growing by 22 percent a year (Exhibit 4 – 16).

²⁹ As of 1996.

As a result of these asset share decreases and channel migration, banks' share of PFS profits has been relatively flat over the past 10 years. Of the total PFS profits, banks earned approximately 43.5 percent in 1987 and 45.8 percent in 1997. This slight increase in profits can be attributed to banks' acquisitions of trust companies, mortgage companies, and credit card lines (Exhibit 4 - 17).

All told, the various forces of change in the industry have had a tremendous impact on the banking sector. New products, new ways of competing, and new competitors present constant challenges, threats, and opportunities. However, banks are not the only providers facing change. In the next section, we discuss how the forces affecting the financial services industry are also influencing the life insurance sector in Canada and around the world.

Impact on Canadian Life Insurance Companies

In the developed world, an aging population and greater customer sophistication about financial services have stagnated the demand for traditional life insurance products. These shifts in demographics and customer preferences have forced life insurers to increase their product range and expand into new geographic markets in search of new growth opportunities. Furthermore, the increasingly global nature of the financial services industry has led to intensified competition from new international players and non-traditional entrants. Together, these changes in customer demands and in the competitive environment have added to the complexity and cost of selling life insurance through traditional career agents. This, combined with declines in the career agent population and productivity, have led to lower margins for life insurance companies and increased sector concentration and consolidation in Canada and around the world.

Changing demand patterns

In Canada, as in other developed countries, the demand for traditional life insurance products has been declining. Typically, the majority of people purchasing life insurance have been between 20 and 44 years of age. This group has the greatest need for mortality protection because its members are in the early stages of their asset accumulation phase and, at the same time, tend to have younger children who must be provided for should either of their parents die young. In contrast, individuals nearing retirement age have a decreasing need for death protection: they have accumulated wealth during their income-generating years and their families have become less financially dependent on them. With the baby-boom generation reaching retirement age, the majority of the population is now beyond the prime life-insurance-buying years (Exhibit 4 - 18). This has led to a decline in the demand for basic mortality protection, which – coupled with the change in tax treatment of life insurance that made it less attractive as a savings vehicle – has contributed to the declining demand for life insurance products (Exhibit 4 - 19).

This declining demand can be examined more closely by looking at the growth of individual life insurance and annuity premiums. Exhibit 4 - 20 shows that while the growth of individual life insurance premiums has remained consistently close to 6 percent in Canada, the growth of individual annuity premiums has been erratic – rising much more rapidly in the 1980s and then dropping sharply in the mid 1990s. In the United States, however, annuities have enjoyed a

continuous period of rapid growth, with a CAGR of over 21 percent from 1986 to 1996 – compared to 7 percent over the same period in Canada.

This difference may be related, in part, to the differing tax status afforded annuities in Canada and the United States. Specifically, annuities may be used as retirement savings instruments in the United States, with the income earned on qualifying deferred annuities sheltered from income taxes. In Canada, however, income on deferred annuities is taxable, making mutual funds that qualify for Registered Retirement Savings Plans (RRSPs) the more popular retirement savings instrument.

In addition to the shift in demographics, growing customer sophistication is also having a significant impact on the life insurance sector. As in other sectors, customers' shift away from traditional products to investment instruments that offer higher returns has exacerbated the decreasing demand for life insurance products. Increasing customer sophistication has also contributed to unbundled products, such as term and universal life insurance and variable life and annuity products, capturing a growing share of life insurance sales (Exhibit 4 – 21).

Unbundled products separate the risk and savings components of traditional whole life insurance, affording customers the ability to purchase higher return investments while retaining low-cost mortality protection (through term insurance) during the early stages of life. Although variable return products typically provide better returns to customers than fixed return products, they also compete directly with a vast array of mutual funds, which generally outperform them. The greater transparency of these products has also enabled customers and their agents to directly compare the value of similar products provided by different companies. As a result, these new products are requiring life insurers to develop new marketing and sales capabilities and are increasing the complexity and cost of life insurers' back-office operations and agent training.

In addition, the shift to unbundled life and annuity products is placing downward pressure on life insurers' product profit margins. Like mutual funds, variable return products are essentially disintermediated investment products and, as a result, their returns tend to track capital market indices. They are also more directly substitutable by mutual funds than traditional, bundled insurance products and consequently are more vulnerable to increasing competition. Therefore, they garner lower margins than high-value-added whole life products (Exhibit 4 – 22). Term life insurance garners even lower margins, since it involves the simple underwriting of mortality risk and provides life insurers with little opportunity to add significant value.

Counterbalancing the shift in demographics in the developed world and the subsequent shift in product mix, is the growing demand for life insurance in developing countries. In response to this demand, life insurance companies have been expanding into developing countries and managing their businesses as multi-local international portfolios.

Intensifying competition

Along with the declining demand for life insurance products, life insurance providers in developed countries are facing growing competition from a wide range of providers. These new entrants are capturing significant market share by providing more focused and compelling value

propositions often at lower costs than traditional players. They are also leveraging the new electronic media to develop new marketing and customer support mechanisms and to distribute insurance products through electronic and direct channels. Examples of these new entrants include banks, worksite marketing companies, mutual fund managers and brokerage companies, direct marketers, financial software companies, as well as online financial product marketplaces (Exhibit 4 – 23).

In many cases, these new competitors are gaining a significant competitive advantage by leveraging their existing capabilities and customer relationships to sell life insurance products. Banks and independent brokers leverage their existing customer bases to cross-sell a wide range of products in addition to life insurance. These advice-based providers build on their high levels of service and long-standing customer relationships to provide clients with a full range of financial services products. Cost-effective worksite and direct marketing channels are also emerging. Finally, electronic software companies and online marketplaces enable customers to shop around for a range of financial services products, including life insurance, without going through an agent. These new “virtual” competitors are more suited to the sale of simple commoditized products, such as term insurance, that customers can easily compare against similar products from many other companies.

In Europe and Australia, banks have emerged as particularly strong competitors in the life insurance sector. In France, banks have captured more than half of the life insurance market, while in the United Kingdom and Germany they have captured just under 20 percent (Exhibit 4 - 24). These high penetration levels suggests that customers in these countries perceive a significant advantage in terms of cost, service, and convenience in purchasing life insurance products through this channel. Research suggests that banks in the United States have also been accepted by individuals in their prime life-insurance-buying years as a suitable channel through which to purchase life insurance. Experience in these countries, suggests that bancassurance has significant growth potential in Canada as well.

From an economic standpoint, banks are particularly well positioned to capture share in life insurance. By leveraging their customer bases and branch networks, banks can achieve more than double the productivity of career agents. This greater efficiency coupled with lower commission payments to their salesforce, is reflected in banks’ low marginal acquisition costs of new policies. In Italy, for example, the cost structure of the bank channel is significantly lower than that of either career agents or financial advisors (Exhibit 4 – 25). This is due, in part, to banks’ stronger ability to turn leads into sales (Exhibit 4 – 26).

Increasing challenges for traditional career agents

The shifting customer demands and the increased competition in the life insurance sector are presenting increasing challenges for career agents. These forces are continually contributing to this channel’s comparatively high costs, declining market share, and low morale and retention. On the cost side, distributing life insurance products through traditional career agents is considerably more expensive than through the various other channels. The cost of a life insurance sale through a career agent tends to be more than one-and-a-half times the value of first-year premiums and more than two-and-a half times the cost of distributing through banks. This face-

to-face channel also suffers an extreme cost disadvantage when compared to direct marketing and online distribution. In addition, the growing range of products sold by life insurance companies has increased both the cost of training agents and the time required to close a sale.

The drop in demand and the increasing competition from other channels have resulted in lower sales figures for agents. The loss in market share in the United States has been significant, with 3 percent of business lost annually during the early 1990s (Exhibit 4 – 27) and still declining. The bulk of this market share has been lost to independent brokers, although direct channels have also grown rapidly. This same trend is occurring in Canada, with most of the loss being captured by independent brokers such as investment brokers, mutual fund companies, independent life insurance agents, and financial planners. The success of these independent brokers has been driven by the greater transparency of insurance product pricing and returns and the independents ability to provide comparison quotes on similar products from a broad range of life insurance companies.

This decline in market share has, in turn, led to low agent morale and declining agent retention rates. As a result, in the United States the agent population has been declining by 1 percent annually in the past few years, while agent productivity has dropped by 4 percent annually. Moreover, new agent recruitment has become more difficult because of negative perceptions about life insurance careers.

Nevertheless, significant opportunities still exist for career agents. Life insurance customers still need financial and investment advice, and certain customer segments still desire face-to-face contact and flexible and convenient service. This places agents in a unique position to maintain strong, long-term relationships with their customers. As a result, this channel can continue to be viable in the long term, provided it can restructure itself to meet the changing needs of the marketplace.

Impact on Other Canadian Financial Institutions

Banks and life insurance providers are not alone in facing the challenges presented by the global forces of change in the financial services industry. Canadian asset managers and credit unions are also feeling the pressure of these forces.

In asset management, for example, the changing customer preferences that have had such drastic effects on other financial institutions have fuelled phenomenal growth in the Canadian retail mutual fund market. Basking in the glow of a 44 percent per year increase from 1990 to 1997 – (58 percent resulting from new assets under management and 42 percent resulting from market appreciation), this market is expected to continue to grow – albeit not quite as fast (Exhibit 4 - 28). In addition to a slowing of fund inflows, returns on assets within funds will also likely slow over the next several years. By any metric (historical market return rates, GDP growth, or sustainable corporate earnings growth), it is clear that the long-term performance of equity markets will ease to more sustainable annual levels, causing a slowdown in growth of assets under management.

In addition, technological advances are enabling new distribution channels with much lower costs and greater customer reach. Furthermore, governments are gradually removing entry barriers to foreign players and limitations on the types and geographies of investment products and channels. As a result, Canadian asset management providers should expect to see increasing competition from both local and international providers. High fee levels in the Canadian marketplace and investor demand for international products will most likely attract strong interest from foreign money management firms, many of whom may seek to build share through highly advertised, lower fee fund offerings or who may enter with lower fee, direct models (e.g., Scudder, TA).

Some new channel-based mutual fund distributors, such as new electronic intermediaries and traditional banks, have already entered the Canadian market. Much like Charles Schwab has done in the United States, these new intermediaries – including discount brokers such as TD Greenline and upstarts such as E*Trade, Mutual Fund Direct, and Sterling – are vying to control the distribution of mutual funds by offering no loads or substantially discounted loads on a broad offering of funds from different providers. Canada Trust, the first major institution to do this, has recently cut commissions on its funds.³⁰ These new forms of competition, the expected influx of competition from foreign players, and pressures to cut fees to boost fund performance when the market is down, will most likely lead to a more US-style model – one that is characterized by multiple distribution channels (of which an increasing number are self-help and direct), broader product offerings, and lower costs to the investor (i.e., lower mandatory loads and management fees). The implication for Canadian mutual fund companies is that they need to look for ways to build, own, or participate in these new direct or third-party channels of distribution.

Credit unions have also felt the influence of these various global forces. In Canada, credit unions have experienced a decline in their share of financial assets over the past few years. From 1992 to 1996, credit unions' share of total consumer credit fell by almost 3 percent per annum – from 13.2 percent to 11.7 percent. The number of credit unions outside Québec fell dramatically, from almost 1,500 in 1995 to 921 in 1997. This declining trend is due primarily to aggressive competition from the banks and new players such as mutual fund providers. We expect the number of credit unions to continue to decline as many very small players will find it increasingly difficult to compete. The forces of change will also have some positive impacts on credit unions. For example, technology has enabled innovation. Citizens Bank, the first branchless bank in Canada, was started by a credit union – Vancouver City Savings. Moreover, given their high scores on customer satisfaction measures, credit unions in Canada could play a key role in filling service gaps for customers who have become disenchanted with the big banks. Some credit unions have already launched campaigns to position themselves as friendly, customer-focused alternatives. For example, Richmond Savings Credit Union has started a campaign centred around a fictional bank, "Humongous Bank," which pokes fun at the service received at large banks.

In the United States, credit unions and smaller community banks have been growing, with more and more new players entering the market each year. These new players are filling the service

³⁰ *The Globe and Mail*, April 8, 1998.

gaps left by larger banks that have merged or were acquired subsequent to the allowance of nationwide banking. For example, community banks and credit unions are starting to play a strong role in California where two large players (Bank of America and Wells Fargo) currently dominate. These new community banks are also starting up in response to customers' desire for the personalized service community-based banking offers (Exhibit 4 – 29).

* * *

The forces of change in the global financial services industry are having or are likely to have a profound impact on Canada's financial institutions. Major shake-ups in the traditional profit centres, complexities in serving increasingly demanding customers in a technology-dependent world, and the resulting pressures on earnings are forcing Canadian players to examine their positions in both their domestic and their foreign markets. In the following chapter, we turn our attention to the competitiveness of Canada's financial institutions and the potential winning strategies they could adopt.

5. Analyzing Canadian Players' Competitiveness and Potential Winning Strategies

Given the dynamic forces of change at play in the global market and their resultant impacts, Canadian financial institutions have no alternative but to take a hard look at their competitiveness and decide how and where they will compete in this rapidly changing environment. Why does the relative competitiveness of Canada's financial institutions matter? And why should Canadians care about their strategies for the future? Because the industry is integral to the health and prosperity of both the Canadian economy and its participants – shareholders, employees, and customers alike. Financial institutions represent over 5 percent of the country's GDP, providing a commensurate level of high-quality employment. In fact, 4.6 percent of the country's total employment is within the finance and insurance sectors – at an average pay level that is 27 percent higher than the national average (Exhibit 5 – 1).

In this chapter, therefore, we seek to understand the factors that ultimately drive the competitiveness of Canada's financial institutions in both their home and their foreign markets and offer a range of potential strategies that, if properly executed, should enable these institutions to “win” in the shifting domestic and global financial services landscape.

Evaluating the Players' Competitiveness

Of the 45 countries surveyed and evaluated in IMD's annual survey on world competitiveness,³¹ Canada ranked 10th in terms of the global competitiveness of its financial services industry – up from 13th the year before. While banking sector efficiency and stock market dynamism scored relatively higher, the cost and availability of capital lowered Canada's overall ranking (Exhibit 5 - 2). Although there may be room to quibble with IMD's methodology, these conclusions raise stark questions for Canada. If Canada's financial services industry indeed ranks among the top 10, how can the individual institutions and the bodies that regulate them build off this achievement to enhance the industry's competitiveness, given its importance to Canada?

Competitiveness can in fact be an elusive notion to define. We readily see the results of being competitive in the business world (revenues and profits rise, the company grows, satisfied customers come back for more) – but it is the basis of why the company grew in the first place that underlies its competitiveness. Through our work with financial services companies around the world, we have identified elements that are consistently present in the most competitive institutions. In this section, we outline these drivers of competitiveness and assess how Canada's players – banks in PFS, banks in wholesale, life insurers, and asset managers – measure up against players in the rest of the world.

³¹ The International Institute for Management Development, Lausanne, Switzerland.

Banks in PFS

In PFS, there are six major drivers of competitive advantage (Exhibit 5 – 3):

1. Operational excellence
2. A distinctive customer offer
3. A strong customer franchise
4. Size
5. A broad product and distribution scope
6. An international presence/skills.

Operational excellence. Of the six drivers of competitiveness, operational excellence is the most critical and the most difficult to develop. Superior operating capability creates a competitive advantage by enabling companies to offer their customers better value for the same or lower price than their competitors. At the same time, they may also be able to achieve higher margins.

Operational excellence requires truly optimizing effectiveness and efficiency to deliver the best possible value. In retail banking, for instance, it requires deep organizational capabilities across a broad range of business functions, from sales and marketing to channel management and transaction processing to superior credit policy (Exhibit 5 – 4). Operational excellence also requires world-class talent, particularly in the executive suite. And it requires a deeply ingrained performance ethic, with every level of the organization motivated and focused on achieving a consistent set of corporate objectives.

Compared to the best operating companies, Canada's banks lack a true performance ethic. Their cost efficiency, while collectively competitive, lags the leading performers in the United States and the United Kingdom (Exhibit 5 – 5). They have only recently tied their compensation directly to improved financial performance. Moreover, though their risk management skills are conventional and sound, the banks' legacy technology inhibits both rapid product innovation and more efficient processes overall. Canadians certainly benefit from the banks' extensive branch, ABM, and alternative channels – but these networks are highly homogeneous. Despite some recent marketing innovations (e.g., mbanx), these channels do not distinguish any of the major banks in any meaningful way.

Finally, many banks are still midway in their transition from being reactive order-takers to customer-focused marketers. As their customer satisfaction levels attest, a gap still exists between the service customers expect and the service banks deliver.

Distinctive customer offer. The second driver of competitiveness for the banks in PFS is a distinctive customer offer – an unbeatable combination of product and price that serves a given customer segment's needs better than the competition. Although this distinctive offer often requires operational excellence, it can also be achieved through superior insights about customer

needs or through a deliberate and narrow focus on specific segments. For large incumbent institutions – like Canada’s banks – this kind of focus is often difficult because their customer bases are typically so diverse and representative of the market at large. This can create opportunities for smaller, specialist players that need not “be all things to all people” and that can afford to favour customer acquisition over customer retention (Exhibit 5 – 6).

Strong customer franchise. One of the best fortifications an incumbent institution can have to defend itself against new competition is a strong customer franchise. Loyal customers will not easily switch institutions or brands, so the incumbent has a decided advantage over competitors in retaining those customers (Exhibit 5 – 7).

Canadian banks clearly have a strong customer franchise. They have a near universal presence in Canada with their branch and ABM networks, ensuring them an unrivalled physical presence across the country. Equally important, they have a sound reputation for being safe places to keep savings. As a result, the banks control the lion’s share of the largest PFS product lines (Exhibit 5 – 8).

Up until now, these franchise positions have proven highly defensible from outside competition. No Canadian bank has been able to move its market share by more than 1 percentage point per year other than through acquisition. However, as we have seen, it is these very same attractive customer franchises that are increasingly coming under attack. Foreign product specialists (MBNA and ING Direct, for example) are going after the attractive cards and deposit businesses, and customers’ investments have attracted whole new business sectors to serve them (such as asset managers).

Size. There is an implicit assumption underlying the recent – and increasing – waves of merger activity in Canada, the United States, and Europe that bigger must necessarily be better. There is ample evidence that larger institutions, with a presence in more markets, can indeed capture more opportunities for revenue growth (so-called economies of scope), gain scale efficiencies in more products and services, acquire new skills and, potentially, achieve better bottom-line financial performance. Being large also gives institutions greater financial strength and flexibility – either through a larger market capitalization or capital and expense budgets – to acquire new market positions and customer bases. However, while it is true that larger institutions have more opportunities for improved performance, it does *not* hold that larger institutions always capture these opportunities or realize the advantages of increased size (Exhibit 5 – 9).

When we explore the issue of whether the benefits of size can be realized in each of the individual drivers of financial performance – revenue, cost, capital, and risk – we discover some interesting facts (Exhibit 5 – 10).

In terms of *revenue growth*, the US experience shows that, collectively, the largest 25 bank holding companies have not grown faster than their smaller counterparts. These 25 institutions (which accounted for 73 percent of the revenues of the 125 largest bank holding companies) grew their revenues at an average annual compound rate of 13.3 percent from 1992 through 1996 – just 0.2 percent faster than the average for the total group. Interestingly, the next 25 largest institutions grew their revenues faster than their larger competitors, averaging 15.1 percent

annual growth during the same period. Even the smallest and next-to-smallest group of 25 institutions grew their revenues by 11.9 and 12.6 percent, respectively. Given these figures, the argument that larger size drives faster revenue growth is not yet supported by the facts (Exhibit 5 - 11). However, the newly formed Citigroup – the largest financial services firm in the world created through the proposed merger of Citibank and Travelers Group – will try to grow revenues aggressively through cross-selling a broad range of banking, brokerage, and insurance products to its combined customer base – a proven talent of Travelers.

In terms of *cost*, size can help in spreading fixed costs, in investing in new technologies, and in building brands. Spreading fixed costs (such as significant investments in technology and back-office processing capacity) over a larger base of activity can result in savings for a larger institution. For example, the per unit cost of processing a cheque or serving a call centre customer falls sharply as the total cost of handling cheques or calls is spread over more customers (Exhibit 5 - 12). US experience shows that efficient consolidators like the former First Bank System (now US Bancorp) are able to apply their operational skill to their acquisitions and actually lower the efficiency ratio of the combined institution. However, this scale advantage reaches practical limits when an operation is already at full scale and volume increases require both variable and fixed-cost additions.

Size definitely increases an institution's ability to invest significantly in becoming more competitive. Technology and brand support are two good examples. The sums large institutions spend on information technology, for example, are staggering. In 1996 alone, the top three banks in the United States spent US \$5 billion. In comparison, the entire Canadian banking sector spent less than US \$3 billion (Exhibit 5 - 13). In an environment where competitive, if not leading, technology is a necessity, even the wisest spenders will need to spend more simply to keep up – and that will require size. Even outsourcing information technology requires investments.

When it comes to building their brands, the amounts large institutions spend are almost as eye-catching. The leading global PFS providers, for example, invest vast sums that are commensurate with their size to support their international brands. In 1996, the top nine US financial services advertisers spent nearly Cdn \$1.6 billion in advertising – approximately \$175 million per brand. By comparison, just 2 years earlier, over 50 Canadian institutions spent a total of \$187 million on advertising – about \$3.7 million per brand (Exhibit 5 - 14). If Canada's financial institutions hope to compete in the broader international arena or even defend themselves successfully at home, they face a daunting challenge just to catch up in brand advertising.

Size alone, however, offers no guarantee of enhanced cost-effectiveness either in the United States (Exhibit 5 - 15) or in Canada (Exhibit 5 - 16). For example, the largest 25 US banks collectively improved their cost position by 1.8 percent annually between 1992 and 1996, matching the collective improvement of the largest 125 banks and lagging that of the second and fourth quintiles (based on size). As well, although theory suggests that the larger institutions could have become leaner faster, their performance was only average. In fact, it could be argued that, given the acquisitive climate in the United States, the smaller banks have a greater incentive to attack their costs. If they do not, they risk being acquired by a more efficient – or at least larger – institution (Exhibit 5 - 17).

There are several factors at play that likely limit large institutions from capturing available scale benefits. Costly integration processes after a merger can hurt the efficiency of previously lean operators – Wells Fargo is one example. Smaller players now have the ability to outsource scale-driven operations, which has resulted in their being at or beyond efficient scale in some areas. Finally, the talent and effectiveness of management as cost-efficient operators may be lacking.

One area where we do see a direct correlation with size is *capital efficiency* – the bank's ability to take full advantage of allowed leverage. The larger the bank, the smaller its Tier I capital ratio, meaning that it has more opportunities to invest in earning assets than its smaller counterparts (Exhibit 5 – 18). However, as the large Japanese banks have proven recently, even being able to leverage your balance sheet more efficiently does not always mean you will do so with attractive assets or with good returns to shareholders (Exhibit 5 – 19).

Finally, while larger institutions clearly have not yet fully captured the opportunities afforded by their size, they do retain an advantage in *risk absorption*. They simply have a greater ability to absorb the credit risks of a single counterparty or country and the market risks of their entire portfolio. Larger institutions can also absorb their own operational setbacks to a greater degree – but they likely remain as exposed to environmental and behavioural risks as smaller institutions (Exhibit 5 – 20).

Broad product and distribution scope. Canadian banks offer their domestic customers a wide range of products and services, with branch relationship managers able to offer all PFS products except insurance (Exhibit 5 – 21). Accordingly, the banks do have the opportunity to benefit through their substantial product and distribution scope. They can deliver a reasonably full range of products through the customer's channel of choice. They can capture their customers' preferences and buying patterns through their databases – and then tailor their future sales and service solicitations accordingly to retain their attractive customers and gain a greater share of their available banking business (Exhibit 5 – 22). However, surveys indicate that Canadian consumers are finding the concept of one-stop shopping less appealing. Furthermore, with the entry of reaggregators and new intermediaries, such as i-money, consumers can now access one interface for dealing with multiple institutions.

International presence. With domestic markets maturing, Canadian retail banks will need to seek growth opportunities in international markets to meet the continued growth expectations of their shareholders. While Canada's banks appear to have a reasonably well-developed international presence, with the five largest institutions garnering at least a quarter of their income from international activities (exhibits 5 – 23, 5 – 24), there are few clear examples of true market leadership in PFS outside Canada. For instance, Royal Bank's European and Asian operations are largely representative offices providing banking services to Canadian individuals and multi-national businesses. Neither provides the institution with any significant local operating experience. There are some notable examples, though, of international PFS successes such as TD's discount brokerage business.

The arena of competition is becoming increasingly global. For years, the "law of one price around the world" has applied to the capital raising and advisory services used by corporate

customers able to access the world's capital markets. Today, this "law" is becoming more applicable not only to the commercial mid-market services but also to selected retail services (exhibits 5 – 25, 5 – 26, 5 – 27). However, "proximity" services – those that are defined by physical presence, such as branch banking – will likely remain local or, at most, regional. Product services, such as credit cards and asset management (product manufacturing), will likely be increasingly contested by international players operating in many markets by leveraging their operating and marketing skills. Given this rapidly changing competitive environment, we need to understand how Canada's banks stack up both as defenders at home and as attackers abroad.

So, how do Canada's retail banks measure up? In their domestic markets, Canada's banks in PFS have notable strengths. They have true customer franchises, with each bank having literally millions of customers who believe these are safe places for their money. And, despite their often vocal complaints about service levels and fees, these customers remain loyal and rarely switch for price-related reasons. The retail banks are by far the largest of Canada's financial institutions, enjoying a nationwide presence and having achieved minimum efficient scale in a number of operational areas, such as call centres and cheque processing. Each of the banks offers full transaction, investment, and credit product ranges – a level of selection competitive with those in developed foreign countries.

Despite these strengths, Canada's retail banks could still be vulnerable to attack. Their value propositions are broadly based, which might ultimately work at cross purposes with their effort to target specific customer groups (e.g., investors and the technology-literate). Moreover, they have yet to fully realize the true operational excellence needed to meet and beat world-class competitors – either at home or abroad. Therefore, we believe Canada's retail banks will need to complement any international growth strategies with deliberate defensive strategies to protect their enviable domestic franchises.

Canada's retail banks face even greater challenges competing internationally (Exhibit 5 – 28). Away from their home markets, they lose many of their domestic advantages – comparative size and a large, entrenched customer base. They also lack the skills, distinctive customer offering, and full-blown international operating presence needed to compete with global winners like Groupe AXA in insurance, Citibank in retail banking, and Merrill Lynch in retail brokerage.

Banks in wholesale

The competitiveness of the world's leading wholesale banks is manifest in their market position, which is dominated by the so-called "bulge bracket" firms (Exhibit 5 – 29). These positions are underpinned by distinctive performance in four management processes (Exhibit 5 – 30):

- **Operations risk management.** A major driver of competitive advantage for wholesale banks (equivalent to operational excellence in retail banking) is the ability to mitigate significant operational risks, such as capital markets execution, and to contain costs (to some degree) in a business where cost growth has outpaced revenue growth for the past 10 years.

- **Financial and risk management.** Leading risk and performance management systems are needed not only to facilitate appropriate risk-return decision making but also to improve risk controls to avoid excessive exposure to a single counterparty.
- **Deployment of people and capital.** The inherent volatility in the capital markets also demands flexibility in the deployment of both people and capital so that returns can be protected in down markets.
- **Partnership-like organizations.** To accommodate their large numbers of talented individuals, the leading investment banks must have partnership-like organizations that reward entrepreneurship and encourage collaboration.

Assessing the performance of Canadian investment dealers against these competitive criteria is difficult. However, a couple of observations are instructive in assessing their overall competitiveness and their ability to compete both domestically and abroad. First, while Canadian dealers virtually control the underwriting of domestic equities, leading US firms have made significant inroads in the domestic debt markets and are the underwriters of choice in raising capital for Canadian corporate customers in international equity and debt markets. Second, if competitiveness is ultimately borne out in financial performance, simply put, Canadian investment dealers not only lag their various US counterparts but also do not contribute to the creation of shareholder value. Specifically, they do not earn the returns the inherent riskiness of their business demands to reward the owners for undertaking these risks. Their profits may be high but not high enough to ensure a satisfactory return on the capital required to earn them (Exhibit 5 – 31).

Life insurers

As outlined in Chapters 3 and 4, Canada's life insurance industry is facing a period of unprecedented change that will demand new skills and requirements to succeed going forward. To stay competitive, life insurers will need to (Exhibit 5 – 32):

- **Revamp and evolve both their product offerings and their delivery systems** (i.e., the traditional career agent). In light of the coming demographic shifts and new forms of competition, life insurers will need to develop much more innovative products and channels and not just deliver conventional protection and savings products through a single distribution network. Innovative competitors have already unbundled the protection and investment elements of traditional products and provided delivery options (e.g., telephone, mail) tailored to meet the requirements of specific customer segments.
- **Achieve benefits afforded by larger players.** As in retail banking, increased size can provide opportunities for improved performance along a number of dimensions. Larger firms can achieve better economies of scale in back-office operations – particularly in the process-intensive variable annuities business. They are better positioned to invest in brand support to gain distribution “shelf space” with third-party channels (e.g., in mutual funds) and to potentially achieve a market capitalization (for stock companies) that will enable them to acquire world-class business systems, international beachheads, and the

leadership talent required to realize the full value of the franchise. In the United States, scale is a particularly strong driver of competitiveness in the individual annuity business (Exhibit 5 – 33).

- **Build the flexibility to grow in the evolving financial landscape.** Flexibility to grow will entail a new set of skills for Canadian players. In the context of the recent announcements to demutualize, not only will life insurers have to navigate that process, but they will also need to demonstrate credible growth plans to their new shareholders – likely through domestic or international acquisitions (e.g., Mutual Life’s \$1.2 billion acquisition of Metropolitan Life’s Canadian operations).
- **Much more rigorously manage their businesses for performance.** Life insurance companies will need to demonstrate an unprecedented degree of rigor in managing their businesses for performance. Their historical returns of approximately 10 percent (or less) on earned surpluses will simply not be acceptable to public shareholders that have earned compound returns well in excess of this level in other financial services sectors (Exhibit 5 – 34).

Canada’s life insurers have a basis for being competitive both at home and abroad. Domestically, Canada’s top six life insurers enjoy a strong position in their traditional channels and products. However, the combined threat of successful bancassurance players and rapidly expanding electronic and direct players continues to hang over their heads. Moreover, a dramatic shift toward lower margin term products and away from whole life products, with customers seeking to invest the differential, will erode life insurers’ profitability unless they are able to recapture the investment portion of the unbundled whole life product.

In contrast to their counterparts in retail banking, Canada’s life insurers have extensive and expanding operations in international markets (e.g., Hongkong). In fact, by the end of 1996, nearly 44 percent of the industry’s premium income was earned outside of Canada, suggesting that a strong base already exists for competing abroad (Exhibit 5 – 35). However, Canadian players will increasingly come up against global consolidators like Groupe AXA and Allianz that will raise the competitive hurdles in international markets (Exhibit 5 – 36).

Asset managers

In many ways, the cost and effectiveness of the services asset managers provide are the most transparent. The returns on mutual funds are widely tracked and quoted, and the cost to purchase funds is generally well understood. Accordingly, the argument for scale will manifest itself in better risk/return performance, lower management costs through both economies of scale (e.g., more customer dollars under management per fund manager) and scope (e.g., leverage investment research across more funds), and the application of “best in class” delivery and product capabilities (Exhibit 5 – 37). The UK experience readily illustrates the ability of larger fund managers to realize lower expenses in operating their funds (Exhibit 5 – 38).

The ability of the Canadian players to achieve this type of scale appears limited. Canada’s retail and institutional asset management businesses are relatively fragmented within their own market

(Exhibit 5 – 39). In retail asset management, for instance, the top 10 players hold a 66 percent share – in institutional asset management, almost a 40 percent share. No one player has greater than an 11 percent share. Moreover, the largest Canadian player, Investors Group, is a light-weight compared to a global giant like Fidelity Investments and lacks not only the scale to spread its management expenses better but also the array of investment choices typical of a larger institution that would enable it to serve its customers more fully (Exhibit 5 – 40).

That said, domestic asset managers may have an inherent advantage over would-be and present foreign entrants. Domestic players enjoy established relationships with their customers in a predominantly trust-based and long-held product category and can better navigate local legislative requirements in providing customer solutions.

Identifying Potential Winning Strategies for Canadian Financial Institutions

Winners are beginning to emerge on the global financial services landscape. In each sector and in many countries, top performing institutions have outpaced competitors in either revenue growth, improved cost efficiency, or both. These players have been rewarded for their success in the capital markets with expanded multiples of their book values and the corresponding ability to grow value for their shareholders, either through acquiring competitors or retaining profits. At the same time, institutions that are finding it increasingly difficult to succeed against the global forces of change have also been revealed. These less successful institutions, both large and small, share a common trait: they have yet to convince their country's capital markets (effectively their owners) that they have both a credible plan to be long-run winners and the performance to back it up (Exhibit 5 – 41).

In this section, we examine the strategies that the winning global players are employing and assess viable options for Canada's financial services institutions.

Winning strategies in world-wide financial services

The winners in the global financial services marketplace appear to be firmly in control of their strategic destinies through either their singularly strong financial performance (e.g., Fifth Third Bancorp) or a combination of performance and the sheer size of their market capitalization (e.g., Travelers Group, even before their proposed merger with Citicorp). More so than any other measure, this analysis of sector-by-sector winners sets out the size of the challenge for Canada's financial service providers (Exhibit 5 – 42).

Banks in PFS. In PFS, the traditional domain of retail banks, five broad strategies emerge among winning PFS providers. These strategies are characterized by excellence in at least two of the six dimensions required for overall PFS competitiveness (Exhibit 5 – 43).

Citibank is the prime example of a leading, global multiline player that excels on all dimensions of PFS competitiveness. One of the most valuable banks in the world, it has effectively pioneered the provision of a full slate of retail banking products and delivery services – on a truly global

basis – with an emphasis on electronic delivery and an extensive ABM network. Its market position and performance are so strong that the ability to execute this strategy may be almost unique to Citibank. Its proposed merger with Travelers further extends its product breadth and customer base.

Lloyds TSB pursues a similar, multiline retail strategy – played out on a national rather than a global level. Lloyds' acquisition of both competitors and complementors, aggressive management of costs, and ruthless divestiture of underperforming businesses in its portfolio (e.g., corporate lending) have made it the leading retail bank in the United Kingdom – and the most valuable bank in the world.

This same multiline, retail banking strategy can also be executed with great success on a regional basis (e.g., multistate), as demonstrated by the success of US players like Wells Fargo and NationsBank, as well as comparatively smaller players like Fifth Third of Cincinnati. Fifth Third is a highly efficient operator (1996 NIX ratio³² of 48 percent) and has achieved a market capitalization equal to CIBC's, with 85 percent fewer assets. However, in the United States, a financial services "endgame" is emerging as even highly successful and comparatively large regional players have recently announced mergers to consolidate their presence in a single region (i.e., BancOne-First Chicago) or build a true coast-to-coast institution (i.e., NationsBank-BankAmerica).

In addition, the emergence of specialists has created a new class of product-focused winners. Fidelity Investments, by far the largest independent mutual fund manager in the world, excels on the dimensions of operational excellence, distinctive customer offer, and an enviable customer franchise. MBNA, the US-based credit card bank, is also strong on these dimensions. It has grown tremendously – with a market capitalization of over \$20 billion by the end of 1997, from less than \$3 billion in 1992 – by focusing solely on originating and servicing credit cards.

Finally, in their rush to get big, many retail banks have created opportunities for smaller, community-based providers to distinguish themselves by being more responsive, providing more local service, and exploiting the service failings of their consolidating competitors. The continuing emergence of new community banks in California, for example, attests both to a demand for these players and to their success. In 1997, 10 new bank charters were granted in California alone – the highest number since 1991. The success of their focus on small- to medium-sized businesses and their personalized service and community involvement is evidenced by their performance: a return on assets of 4.4 percent in 1997, compared to the 1.2 percent average for all California banks.

Banks in wholesale. Wholesale banks face not only choices about which markets to participate in and what breadth of services to provide but also additional choices relative to the extent they will put their finite balance sheet capacity to work (i.e., at risk) to provide these services. The full-service, global arena is dominated by US-based Goldman Sachs, Morgan Stanley, and

³² NIX ratio is defined as non-interest expense divided by operating revenues. It is a measure of a bank's efficiency.

Merrill Lynch. Although US-based, these are truly global organizations that garner a significant – if not the main – share of their earnings from capital raising and advisory activities around the world.

Other players have found that through more targeted – but still broadly based – wholesale services, they are able to compete and perform well with a national or regional focus (e.g., Chase Manhattan in the United States, Schroeders and Jardine Fleming in Europe and Asia). Similarly, a number of niche players have leveraged either their leading regional capabilities and market knowledge (e.g., Lazard Freres in merger and acquisition advisory) or a targeted service line to assemble a sustainable franchise (e.g., Alex Brown for technology company IPOs) (Exhibit 5 – 44).

The success of these strategies is clearly demonstrated by the sustained, above- market returns each of these players has earned over the past several years (Exhibit 5 – 45).

Life insurers. Winners in the life insurance business have pursued strategies along two fronts – focus and growth – with successful players emerging from each camp (Exhibit 5 – 46). These players have followed highly focused strategies that have enabled them to achieve superior results, even in their slow-growing developed markets. USAA, for example, has an enviable record of premium growth that it generated by focusing exclusively on retired US service officers and their families. It has recently broadened its focus somewhat to include enlisted personnel with honourable discharges and allied service branches (e.g., the reserves, the Coast Guard). However, it still remains focused on tightly defined customer segments to which it can tailor its product offerings. Northwestern Mutual has focused on excellence in managing a single channel – the life insurance agent – and has built a highly skilled, value-adding agent force that is more productive and maintains higher retention rates of attractive customers' business.

A product-focused, or insurance “category killers” strategy has produced winners like UNUM, which concentrates on disability insurance. While some focus only on a part of the business (e.g., Great-West in manufacturing), others rely on business that was seemingly unattractive to begin with (e.g., Consecro and Sun America harvesting closed books of business).

Other insurance players have improved their performance through one of several growth strategies. Aegon and Sun American have been very successful consolidators in recent years, not only in purchasing companies but also in retaining the acquired customer bases and improving the effectiveness and efficiency with which these customers are served. Their skill in the consolidation game has helped them achieve market capitalization growth exceeding that of the total US life insurance industry by a factor of nearly 6 times from 1993 to 1996. (Exhibit 5 – 47).

Other proven growth strategies and their practitioners include new products and services (Hartford), new business arenas (New York Life), new geographies (Manulife in Asia), and development of new distribution channels (Primerica marketing through its entire network of retail financial services companies).

Asset managers. The asset management business has proven to be profitable for many of its participants, whether they bring distinctive skills or not. Going forward, two winning models will

likely emerge. The first will be the growth of truly global players – those that bring a full suite of international investment products and services to an equally global set of investors (as opposed to simply local). At best, the service levels of these providers will meet those of the best local operators, and their services could effectively be described as multi-local. The second model will consist of players with a narrower product and service focus but that also serve a global set of customers.

The underlying logic of both models is the need to increase scale in fund operations while serving the broadest set of investors, wherever they reside – in a sense, following the money. Local investors' preferences, familiarity with local providers, and local regulations that benefit local payers (i.e., pension plans that limit the amount of foreign content in an investor's portfolio) may serve to slow the development of the global provider model, but will not stop it (Exhibit 5 – 48).

Viable strategies for Canadian players

Against the dizzying array of challenges facing Canadian financial services providers, we believe there are a number of viable strategies for Canadian institutions going forward. Which strategy to choose will depend on the institution's view of its competitive starting point and on its perception of how the industry's competitive dynamic will ultimately unfold. For example, a bank's view on whether it is losing its domestic footing against new entrants and alternative providers or whether it will continue to enjoy a leading share in its core businesses will shape both the direction and the pace of its strategic moves (Exhibit 5 – 49).

Canadian banks in PFS. To defend their domestic franchises against attack from various sources, Canada's banks can choose to follow one of five possible strategies:

- 1. Fully extend multiline capability of major players.** The banks could reinforce their position as the nation's one-stop providers of financial services by fully extending their product-line capabilities. At present, the banks have lagged in providing integrated asset management for retail customers (e.g., planning advice, provision of third-party funds). They could remedy this by enhancing their asset management delivery capabilities through acquiring independent retail brokers, financial planners, or trust companies.
- 2. Further consolidate Canadian retail banking.** As we have seen in the United States and Europe, in-market consolidation has spurred improved performance and value growth in a number of institutions and, in some cases, created some of the most successful and valuable banks in the world (e.g., Lloyds TSB, NationsBank). To date, consolidation in Canada has been limited to "cross-pillar" acquisitions.
- 3. Seek other opportunities to achieve economies of scale and skill.** Current industry joint ventures in back-office processing could be extended beyond their present scope to capture additional economies of scale and skill. However, willing partners with similar needs are required to capture the opportunity.

4. **Fully exploit third-party product offerings.** Given their unparalleled distribution reach within Canada, the banks could leverage this asset by distributing the offerings of world-class product manufacturers for a fee. Banks have been reluctant to do so in the past fearing the potential displacement of their own products (and the retention of their value-added within the bank's own earnings). However, the first bank(s) to acquire proprietary distribution rights to leading product providers could gain significant domestic share by providing distinctive, world-class products to Canadian customers.
5. **Focus on service to targeted communities/segments.** Taking a page from California's community banks, a community-focused strategy argues that through high-quality, front-line service targeted to distinct community groups, PFS providers such as the banks – but more likely the trusts, credit unions, and caisses populaires – could realize higher penetration and customer retention levels in these markets. A twist on this strategy is that the community of focus could be a behavioural or demographic segment of the population rather than a geographic one. This is the strategy being pursued by the “virtual” bank launched by Citizens Bank, which targets technology-literate individuals with a concern for the environment and offers them highly competitive rates and responsive online and on-call service.

In competing abroad, Canadian banks can learn from the recent foreign entrants to the Canadian market. One possible path is entering a market on a de novo basis as ING did in coming to Canada. This is likely the most risky strategy for going abroad, and it requires a distinctive business system or customer offer in the host market. Exporting the traditional Canadian retail banking model into developing markets appears much more viable than doing so in the developed markets of the United States and Europe.

Rather than going in from scratch, Canada's banks could extend their competitive presence abroad through either acquisitions or a network of joint venture partners. Scotiabank appears to have pursued this strategy fairly aggressively in Latin America, and TD has been even bolder in its major acquisitions of discount brokerages. Royal Bank has just started to play this game with its announced purchase of Security First Network Bank of Atlanta – the first Internet bank in the United States. Each approach requires developing operating skill in the target's market and a high valuation multiple (market to book basis) to ensure that acquisitions will not overly dilute existing shareholders. The development of an international network brings its own challenge of operating through shared control and identifying truly complementary partners.

A final means of competing abroad would be a merger of equals with a foreign bank. As with domestic consolidation, there is currently no precedent in Canada for such an approach. The underlying logic would be to identify a partner with a complementary business (e.g., asset management manufacturing and distribution), since the benefits to such a partnership could not come from rationalizing physical distribution given the lack of overlap.

Canadian banks in wholesale. As discussed earlier, winners have emerged across the wholesale banking spectrum in terms of strategies that cover geographic and product breadth. These winners in wholesale services are represented mainly by leading investment banks, integrated wholesale players, and boutique firms. Beyond the strategic position characterized by global

presence and full service – dominated by Goldman Sachs, Merrill Lynch, and Morgan Stanley – there are still strategic spots for Canadian dealers to play. Canadian firms, both domestically and abroad, are constrained only by the skills they are able to assemble and retain in the strategies they pursue.

Beyond these fundamental choices of which clients and product markets to focus on, a strategic imperative for the Canadian players is to improve their returns. Rigorous balance sheet management (e.g., determining which businesses get capital, which capital intensive businesses need to shrink), identification of new growth options (e.g., structured products, securitization, high yield), and sorely needed productivity improvement are required for Canada's wholesale dealers to earn value-creating returns (Exhibit 5 – 50).

Canadian life insurers. With the four large mutual players announcing their intent to demutualize and become publicly-traded, Canada's life insurance companies will be pressed to articulate their strategies for winning in the evolving Canadian life insurance market. Again, in gathering the learnings from other markets and in adapting them to the uniqueness of the Canadian marketplace, we have identified four potential strategies for Canada's life insurers.

- 1. Further consolidate the Canadian life insurance market.** With their newly minted “acquisition currency,” the better performers would be able to effect the consolidation of the Canadian life insurance sector, seeking the scale and scope benefits realized in other parts of the world. The life insurers could act as product manufacturers, creating new businesses and products to be distributed through bancassurance players.
- 2. Broaden out into investment and retirement products.** The life insurers themselves could seek to evolve into broader-band asset management specialists by acquiring brokerage, mutual fund, and/or trust capabilities. Under this scenario, the life insurance companies would need to modify their traditional channel, the agent, into more of an investment advisor – a challenging task currently under way in several US companies.
- 3. Become broader line PFS players.** The logical extension of the specialist role, is to broaden life insurers' PFS capabilities even further in sourcing credit and transaction products. They could eventually become “quasi-banks” – an investment-focused alternative to the incumbents.
- 4. Expand internationally.** Canada's most international financial sector could continue to expand internationally – most likely in developing markets like Latin America and non-Japan Asia where the penetration of the life insurance product, let alone total coverage amounts, are low compared with those of developed countries.

Canadian asset managers. Of all the domestic players, Canada's domestic asset management companies can afford to bide their time. They are highly profitable and benefit from some structural advantages (i.e., RRSP content rules) that prevent the majority of Canadian investors from seeking investments from non-Canadian providers. That said, some opportunities are available for asset managers to advance strategically. First, they can extend their domestic services through affiliations with other financial institutions, broadening their appeal and access

to additional investors (e.g., Trimark's acquisition of Bayshore Trust gave it access to the payments system) and further product innovations. Second, they can differentiate themselves domestically through innovating with direct and electronic delivery methods. For example, Trimark now offers its funds through E*Trade, TD Greenline, and Mutual Fund Direct. And finally, they can form international partnerships to gain access to global investment products.

Whether the ultimate industry endstate is a landscape of truly global players that are either multi-local in all products and services or focused on a few, the pace of this evolution will likely accommodate a number of domestic moves by Canadian asset managers who currently are better positioned to wait and see how their world develops.

* * *

In summary, Canada's financial institutions must do two things going forward. First, they must "bulk up" on the basic elements of competitiveness to be better positioned domestically and abroad. And second, they must make fundamental choices of not only "where" but "how" they will choose to compete in this new world of financial services.

6. Evaluating How Well Canadians Are Served

The rapidly evolving financial services landscape has implications not only for providers but also for customers. Are these changes good for customers? In what ways will they benefit? How well are Canadian customers being served by their financial institutions? In light of the forces affecting the industry, will Canadians continue to be well-served in the future?

“Well-served” means different things to different people. Customer service and satisfaction are fairly subjective measures driven by personal experience and are evaluated by individuals with different backgrounds, expectations, and assessment criteria. Evaluating customer service in financial institutions is particularly difficult because financial services are intangible and product attributes may not be easily discernible.

Businesses, for instance, demand different services and products from their financial institutions than consumers do. Similarly, different sized businesses require different services. For example, consumers’ main sources of satisfaction are convenience, trustworthiness, timeliness, personalized service, accuracy, price, and safety. Business owners, however, are more concerned with access to financing, treatment by their banker, and the quality and price of services. Therefore, it is necessary to segment Canadian customers into categories and evaluate customer service for each group. Business customers can be segmented into wholesale, commercial mid-market, and small- and medium-sized businesses – while the consumer segment is relatively homogeneous.

To evaluate customer service for each segment, McKinsey has developed a framework that incorporates the four major components of customer service: pricing, quality, choice, and accessibility (Exhibit 6 – 1). We have used this framework to provide a cursory view of the weight of evidence available on customer service. Analysis of such a complex question inevitably involves a large element of judgment. We have examined a number of ways in which customer service can be compared and quantified and, though the results are not exhaustive, they do provide a weight of evidence from which to draw conclusions.

Wholesale Business Segment

The wholesale segment consists of large multinational corporations with sales that typically exceed \$250 million. These firms have complex banking needs and usually employ in-house financial professionals. The majority of their financing needs, both equity and debt, are increasingly met through direct access to the capital markets. These firms can tap into an array of financial institutions both in Canada and throughout the world and are sophisticated users of financial services products. Institutional investors or the “buy side” are another part of the wholesale banking segment. They are becoming increasingly powerful and demanding higher service levels, greater access to information, and more specialized risk management services.

Pricing. Pricing in wholesale banking has decreased over the past 10 years. Commissions on investment grade debt and high yield have decreased for both domestic and international issues. In the United States, declines in spreads for debt instruments have been particularly pronounced,

with a 10-year CAGR of –5 percent for investment grade debt (Exhibit 6 – 2). As noted in Chapter 4, Canadian fixed income margins have also declined: with a 22 percent annual decrease in spread for corporate issues between 1993 and 1996. Spreads between the US and Canadian markets are comparable; however, differences do exist in IPO and equity spreads (less global businesses) where, on average, Canadian firms pay 276 and 113 basis points, respectively, more than US firms (Exhibit 6 – 3). Fees may be higher in Canada for equity originations and IPOs due to the relative size of deals, which are presumably smaller in Canada. We expect to see further convergence in pricing as global providers make inroads into the Canadian market and effectively squeeze spreads to the benefit of wholesale customers.

Current account pricing has actually been declining over the past few years. Account services are commoditizing for large corporations, with service fee decreases of 21.8 percent since 1990.³³ In addition, discounting has become more common, with 92 percent of participants in the Stewart Associates study reporting discounts on basic service charges.

Quality and choice. Canadian wholesale banks still dominate in the domestic equity market where they bring their expertise to bear at the company, industry, and country levels. They also bring their substantial retail distribution capabilities and their established relationships with institutional investors. Canadian providers also dominate the corporate lending business. However, most corporations have banking relationships with multiple providers, including subsidiaries of foreign-owned banks (Exhibit 6 – 4). According to a Conference Board of Canada survey,³⁴ chief financial officers rate Canadian institutions highly on such factors as: knowledge of industry, price, reliability, and knowledge of company – but rate them lower on their ability to conduct international transactions.

For domestic issues, Canadian institutions have the skills, local knowledge, and distribution to serve large corporations well. Consequently, Canadian providers dominate the domestic equity and debt markets. However, for large global debt and equity issues, the perception among Canadian corporations is that the level of expertise and service of Canadian providers is not at par with global industry leaders such as Morgan Stanley and Goldman Sachs. This is evidenced by the fact that a significant number of Canadian corporations turn to non-Canadian providers for their global wholesale banking needs (Exhibit 6 – 5). US providers have more experts and specialists on staff, which is warranted by the larger US market. Similarly, foreign corporations are not utilizing Canadian providers for their international financing needs. No Canadian providers, with the exception of CIBC World Markets in high-yield debt issues, are listed in the US Top 15 League Tables.³⁵ As well, in the higher spread, fee-based business of mergers and acquisitions, no Canadian providers rank in the global top 10. In 1997, four Canadian companies had M&A deals over US \$1 billion; all engaged the services of non-Canadian advisors (Exhibit 6 – 6).

³³ 1997 *Survey of Bank Fees*, Stewart Associates. Stewart Associates is a Canadian consulting firm. All references to Stewart Associates surveys are Canadian data only.

³⁴ The Conference Board of Canada survey of large Canadian corporations – commissioned by the Task Force on the Future of the Canadian Financial Services Sector.

³⁵ Investment Dealers' Digest.

Accessibility. Canadian corporations are increasingly tapping into global capital markets for their financing needs. In 1996, 60 percent of Canadian corporate bond issues were international (Exhibit 6 – 7). As discussed in Chapter 3, wholesale banking is effectively global, with demand and supply for capital flowing irrespective of geographic boundaries. Accordingly, accessibility to financing and a range of providers is not a major issue with this customer segment. They have access to global capital markets and global providers. If a Canadian investment bank's skills and expertise are not sufficient, it is easy enough for Canadian corporations to go to New York to obtain the necessary services. Global providers are more than happy to fulfill these unmet needs. It is unclear, however, whether large Canadian corporations would actually prefer to deal with Canadian investment banks but do not because of size limitations (i.e., Canadian investment banks are not large enough to facilitate large deals due to risk constraints) and/or lack of skills and expertise. Regardless of preference, Canadian corporations have access and options both in Canada and in many other markets.

Institutional investors

The “buy-side” of wholesale banking consists of institutional investors such as pension fund managers, insurance companies, and mutual fund managers. The rapid growth in assets under management in these segments means that these buyers exert considerable influence over the wholesale banks. Evidence of this power can be seen in the 10 percent CAGR decline in commissions on large trades over the past 10 years (Exhibit 6 – 8). This group also has access to global markets and can obtain research and information from a wide range of providers. An example of the shifting power toward institutional investors is the decline in custodial fees – 15 percent over the past 3 years. In addition, discounting is more common, with over 61 percent of participants in a Stewart Associates survey reporting discounts on Canadian security transactions.³⁶

Commercial Mid-market Segment

The commercial mid-market consists of corporations with sales typically in the \$20 million to \$250 million range. These firms have recognizable organizational structures and may be either publicly or privately owned. They have some access to capital markets but do not have the same level of expertise and sophistication as larger corporations.

Pricing. The commercial mid-market also has access to the capital markets and consequently, has benefited from the declining spreads in financing instruments. However, as Exhibit 6 – 3 illustrates, the pricing on domestic equity issues is higher than on international issues. This spread difference can be explained to some extent by a smaller market – however not entirely. The residual difference suggests that Canadian corporations pay more to issue domestic equity.

Quality and choice. The commercial mid-market story is similar to that of the wholesale segment. It has a choice of providers, both Canadian and international, for its capital market

³⁶ 1997 Survey of Custodial Fees, Stewart Associates.

needs. Even for small issues, there are a number of niche providers who offer advisory and issuance services. For its banking needs, this segment uses both Canadian and foreign-owned banks.

In The Conference Board of Canada study, the commercial mid-market segment gave Canadian providers high ratings on their industry and company knowledge. In general, this segment gave higher ratings for Canadian institutions than did the larger corporations, except on pricing (Exhibit 6 – 9). This segment rated Canadian providers as stable and reliable but slow to innovate and introduce new products.

Accessibility. Accessibility is also not a major issue for the commercial mid-market. It can access a large number of suppliers for its capital market needs and an increasingly large number of domestic providers for its financing needs. New providers such as Newcourt Credit and Northern Telecom have aggressively entered this segment by offering alternatives to traditional bank financing, such as equipment leasing. Newcourt Credit is able to offer competitive pricing through its use of securitization, quick turnaround time, and reduced administrative costs and complexity.

Small- and Medium-sized Business Segment

The small- and medium-sized enterprises (SME) segment typically consists of organizations with fewer than 100 employees. These firms usually have an owner-manager who makes most of the financial decisions. They have limited access to capital markets, and their level of financial sophistication is low compared to other business segments.

The SME segment is particularly important to the Canadian economy. It represents more than half of private-sector employment, accounts for 43 percent of the gross domestic product, and creates the majority of new jobs (87 percent of new jobs in 1996 were attributable to this sector).³⁷ SME relationships with the banking sector in Canada has sparked substantial media attention, surveys, reports, private-sector and government studies, and debate. This attention centres on SMEs' main concerns about banking – access to credit, account manager turnover, and pricing.³⁸

Pricing. Scanning any Canadian newspaper will surface SME concerns about bank pricing. There has been considerable media attention given to SME owners in recent months complaining about the banks' service charges and interest rates. SME owners believe they are charged too much and that bank pricing has gotten worse over the past 3 years.³⁹

From the SME perspective, what matters most is the interest rate the company pays on its debt. To determine if interest rates charged to SMEs are reasonable, we compared rates in the United States and Canada. However, simply comparing absolute interest rates between the two countries

³⁷ Industry Canada.

³⁸ Canadian Federation of Independent Business.

³⁹ Canadian Federation of Independent Business; literature searches.

is not a fair comparison because of the different interest rate environments, the inflationary expectations, and the exchange rate. Therefore, we compared the spreads between the rates paid and a cost of funds benchmark rate.

Canadian SMEs are getting a good deal on price when examined on an interest rate spread basis. A study completed by the Loan Pricing Corporation (a reputable New York-based pricing service) found that the spread between the average rate and the cost of funds was significantly lower in Canada (Exhibit 6 – 10). The spread for businesses with sales under \$20 million was even lower, with a differential of approximately 125 basis points. This data is not fully conclusive, since it is unclear if the US and Canadian markets have similar risk profiles; however, it does provide an indication of relative pricing levels.

Another indicator is the spread between the prime rate and either the cost of funds or the Bank of Canada rate. Ordinarily, loans are priced as a function of the prime rate plus a risk premium. In Canada, the spread between the prime rate and the Bank of Canada rate is lower than the spread between the US prime rate and the Federal Funds rate (Exhibit 6 – 11). Furthermore, the range of interest rates is much narrower in Canada. Most SME loans in Canada are priced between prime and prime plus 3 percent, with an average of prime plus 1.75 percent. In the United States, this range is much broader, and loans can be priced anywhere from prime to prime plus 8 percent, with an average of prime plus 3.25 percent. The narrower range in Canada may imply that Canadian banks are not adequately pricing for risk, which may have implications for SME accessibility.

Most SMEs are also dissatisfied with the value they receive for the service charges they pay. A Canadian Federation of Independent Business study, entitled “The Price is Not Right,”⁴⁰ found that over 60 percent of SMEs are either somewhat or very dissatisfied with value they receive for their money. In addition, 71 percent of respondents feel that bank service charge conditions are somewhat or much worse than 3 years ago. This is consistent with the results that showed overall dissatisfaction with service charges. SMEs are primarily frustrated with the seemingly arbitrary nature of service charges and the inconsistent treatment of SMEs. For example, there has been much confusion over the past few years as institutions switched back and forth between bundling and unbundling service charge packages. SMEs are also frustrated because fees are now being charged for previously free services without any perceived incremental benefit. According to the Stewart Associates’ survey, “list prices for current account fees remained virtually unchanged between 1994 and 1997 but have increased 7.1 percent since 1990.”⁴¹

It is difficult to compare service charges across different countries or even among Canadian institutions because it is difficult to define average use. We derived an estimate for average usage for a small SME through discussions with those we surveyed for the international comparison. Assuming that the SME was not a large cash handler, we used an average of 25 debit and/or credit transactions per month and assumed a minimum monthly balance greater than \$1,000. Using this definition, pricing in Canada is in the middle. The average monthly fee in Canada is

⁴⁰ “The Price is Not Right,” December 1997, Canadian Federation of Independent Business.

⁴¹ 1997 Survey of Bank Fees, Stewart Associates.

\$18 versus \$8 in the United Kingdom, Sweden, Germany, and the Netherlands. Americans and Australians pay higher monthly fees of \$27, on average. One factor influencing this result is that European SMEs have moved more quickly to electronic payment methods and are less reliant on cheques than Canadian, American, and Australian SMEs. Canada also comes out in the middle for merchant discount rates on credit cards, transaction fees for acceptance of debit cards, and telephone banking charges (Exhibit 6 – 12).

Quality. Recent CFIB surveys and the Thompson Lightstone study⁴² suggest there are gaps between SMEs' expectations and the quality of service delivered by Canadian institutions. Ratings for primary contacts deteriorated in terms of accessibility, prompt follow-up, reaction time, and interest. SMEs also complained about the lack of relationship continuity (60 percent of respondents in the CFIB study reported that they have had more than one account manager in the past 3 years) as well as specific complaints about banks' lack of responsiveness, lack of understanding of their businesses, and low quality of service at the branch level. However, when asked to rate the overall service quality, 70 percent said they were satisfied.⁴³ On average, SMEs tend to stay with their primary institution for more than 10 years (Exhibit 6 – 13). This high satisfaction rate and the length of tenure may imply some congruence between SMEs' expectations and banks' service quality. Conversely, these high ratings may also suggest that SMEs feel they have limited options and that the institution with whom they are dealing is no better or worse than the other banks.

Choice. SMEs in Canada have fewer choices than those in the United States. There are more community banks and credit unions in the United States and more alternatives to bank financing, such as leasing and credit card companies. Moreover, the non-bank segment is much more developed in the United States, and focused specialty providers like Wells Fargo are particularly aggressive in pursuing the SME segment (Exhibit 6 – 14). Non-bank providers in Canada are starting to emerge, however, with companies such as Newcourt Credit starting to offer leasing options for SMEs.

Since US non-banks price according to risk, the range of rates charged is much wider than in Canada. On the other hand, more businesses are eligible for credit. If non-bank providers are to be successful in Canada, they will have to educate SMEs about risk-based pricing and the tradeoffs between higher prices and increased credit.

Accessibility. SMEs' access to financing is a major area of concern and media attention. There have been many studies on accessibility of credit for SMEs, not only in Canada but also in most OECD countries such as the United Kingdom, Australia, and the United States. In Canada, the complaints centre around a lack of alternatives to bank financing, high collateral demands, and low perceived willingness to lend by Canadian banks. These difficulties have resulted in a

⁴² *Small and Medium Sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions*, 1997, Thompson Lightstone & Company Limited.

⁴³ Ibid.

declining percentage of SMEs seeking financing. Accordingly, the CFIB has placed this issue high on its priority list.⁴⁴

SMEs see two fundamental access problems: access to bank financing and access to capital in general, including equity financing. Canadian banks are criticized and held accountable for both problems. Although creating an environment that encourages the availability of equity financing is important, for the purposes of this report we have chosen to focus primarily on access to bank financing.

Banks are the dominant providers of SME debt financing. And, according to a Conference Board of Canada study, domestic banks hold 50 percent of SME financing (Exhibit 6 – 15). Although banks receive criticism about loan approval rates, the financing success rate as measured by the percentage of approved formal loan applications is high at 88.9 percent. This is down from 1987's level of 91 percent but, in absolute terms, it is still high.⁴⁵ CFIB findings confirm these strong approval levels. The approval rate for new loan requests was also high at 82 percent according to figures from Thompson Lightstone. However, these findings are not consistent with literature searches and anecdotal observations, which put the approval rate at less than 70 percent.⁴⁶ The 88.9 percent rate may overstate SME accessibility to credit because it measures the number of formal loan applications approved and does not take into account the SMEs that were discouraged from applying.

Banks, in conjunction with the CBA and the Bank of Canada, have recently started to track SME⁴⁷ borrowings and outstandings (Exhibit 6 – 16). There has been overall growth in SME outstandings since 1995 at 3.7 percent annually; however, this growth has occurred in loans over \$25,000. The percentage of total SME loans for this group as well as the absolute levels under \$25,000 has declined slightly since 1995. In addition, growth rates in SME credit in the United States have been higher than in Canada, especially in the under \$100,000 category (Exhibit 6 - 17). We cannot draw strong conclusions regarding accessibility from this data, as the decline in Canadian loans was fairly small and the higher growth in the United States can be at least partially attributed to a higher economic growth rate during that period.

Banks have tried to address SMEs' concerns about accessibility with a plethora of new SME initiatives. Programs aimed at knowledge-based industries and exporters are examples of two such initiatives (Exhibit 6 – 18). Banks have also partnered with Crown corporations to increase the supply of credit through targeted programs. The federal government and the banks have also aggressively marketed and implemented the Small Business Loan program, a government-guaranteed program to ease collateral requirements for small businesses and assist new borrowers. On balance, banks' efforts have been oriented more toward special initiatives than toward fundamental changes in skills, approach, and attitudes.

⁴⁴ Canadian Federation of Independent Business; literature searches.

⁴⁵ Thompson Lightstone study.

⁴⁶ Literature searches.

⁴⁷ SME definition is for borrowings less than \$1 million.

Looking ahead

Technological change should benefit the SME segment and result in higher service levels and more accessibility to credit. Technology has enabled new entrants – such as Wells Fargo, whose value proposition focuses on service and responsiveness (Exhibit 6 – 19) – to start offering services in Canada. Technology will also enable SMEs to compare pricing and service offerings between institutions more quickly and easily. Not only will offers improve, but more information and access to it should help SMEs become more sophisticated and knowledgeable about financing and improve their ability to tap financing sources.

Consumer Segment

Individuals use a wide range of personal financial services. Since most of the negative public perceptions are aimed at the banking sector, this section will primarily assess Canadian banks. For comparison purposes, we will touch on life insurance and retail mutual funds in the discussion of pricing.

Pricing. In Chapter 2, we saw that Canadian banks' net interest margin declined 2.8 percent per annum over the past 10 years, while their non-interest income increased 5.1 percent. These aggregate figures suggest that Canadians are benefiting from lower spreads but are paying higher service charges. In fact, Canada has lower net interest margins than all surveyed countries except the Netherlands. Conversely, it has one of the higher non-interest income percentages. To understand these aggregates, we compared spreads and fees for specific products and services.

In mortgages, for instance, Canadians benefit from competitive spreads. Although different conclusions could be drawn depending on the starting point, spreads on 5-year mortgages have declined over the past 20 years, giving Canada lower spreads than selected European countries and a comparable spread to the United States (Exhibit 6 – 20). For consumer loans, an OECD analysis shows that Canada had the second lowest spread between the average consumer loan rate and the market rate from 1990 to 1996 (Exhibit 6 – 21).

The spreads on credit cards, however, are much lower in the United States than in Canada. The US credit card industry has experienced rapid change with new, aggressive monoline providers stealing significant share from traditional bank providers. This increased competitive intensity has reduced interest rates and spreads and resulted in enhanced choice and customization for US consumers. A comparison of credit card spreads is difficult because of the variety of cards available and the multiple payment options, interest rates, and fee options. However, on standard credit cards, Canadians typically pay higher fees and interest rates (Exhibit 6 – 22).

General banking service charges are a contentious issue in most countries. Complaints about service charges receive considerable media attention, and consumers are annoyed by them and do not see the value for the money. Despite the anecdotal observations and publicity, survey results show that more than half of respondents consider financial institutions' service charges neither

very unfair nor somewhat unfair.⁴⁸ However, the percentage of people answering somewhat unfair or very unfair has been increasing at 3.8 percent per annum since 1990, with a pronounced increase since 1994 (Exhibit 6 – 23).

To determine how Canadian consumers fare on service charges compared to other countries, we conducted an international survey of financial institutions. The challenging aspect of the survey was to compare similar accounts and services across different countries. Because the payment structures of the surveyed countries are so different, a direct transaction comparison would not accurately reflect service charges (Exhibit 6 – 24). For instance, most European countries' use of cheques is low, making a comparison of cheque-writing prices difficult. We therefore used Industry Canada's definition of average monthly product usage (eight cheques per month, six point-of-sale transactions, five ABM transactions – with a minimum balance of <\$1,000) as a starting point and then adjusted it to each country's specific circumstances as they pertained to payments and service offering. The average monthly fees in the survey represent the best approximation of what a typical consumer would pay for the same level of banking service in each of the surveyed countries.

According to the survey, there is wide variation in average monthly service charges between countries (Exhibit 6 – 25). UK financial institutions typically charge no fees on accounts, provided the account has a credit balance. Germany, the Netherlands, and Switzerland – with their reliance on electronic payments – have relatively low service fees (Exhibit 6 – 26). Fees are typically higher in the United States; however, this may be overstated because it includes only commercial and community banks. If the non-bank sector was included in the calculation, US average service charges would most likely decrease because the non-bank sector has a high no-fee component to its transaction accounts. Compared to these other countries, Canadian banks' monthly service fees are about average.

There are also differences in service fee levels among Canada's banks (Exhibit 6 – 27), and they offer a wide variety of fee packages and account types. However, despite brochures and elaborate Web pages, it is very difficult to directly compare their service fees and offerings. According to survey results,⁴⁹ 22 percent of respondents say that they are not very satisfied with the amount of information banks provide about their service charges (Exhibit 6 – 28).

In terms of distribution, electronic channels are more cost-effective for the banks than the traditional branch channel (Exhibit 6 – 29). However, from a consumer perspective, these new channels provide little price benefit over traditional channels. In essence, technology adopters are subsidizing the cheque and branch users. Canadian banks are just now starting to offer price differentiation based on channel choice. As more and more Canadians migrate to electronic channels, however, transactions pricing should start to decline – as it has in the European banking system, which is much more electronic than Canada's.

Not only are most consumers annoyed by service charges, they also believe that increased bank profitability is directly attributable to the service fees they pay. From an institutional perspective,

⁴⁸ Goldfarb Report 1997.

⁴⁹ Goldfarb Report 1997.

however, transaction service fees are not a large contributor to bank profits. On average, banks derive 50 percent of their transaction account profitability from a mere 5 percent of their customers. Furthermore, retail service fees typically represent less than 5 percent of total bank revenues. Despite their annoyance over service charges, Canadian consumers are not being excessively charged relative to other countries.

The results are similar in the life insurance sector. Compared to the other surveyed countries, a 35- to 45-year-old non-smoking male would pay \$780 per year for a 5-year life insurance policy of \$100,000 in Canada – just below the cross-country average life insurance premium (Exhibit 6 - 30).

In mutual funds, Canadian consumers do not fare as well. Canadians pay more for mutual funds than consumers in the United States, Germany, Japan, and the United Kingdom from both banks and independent mutual fund managers. The management expense ratio (MER) is higher in Canada for both domestic equity and domestic bond funds (Exhibit 6 - 31).

Quality. Banking, compared to other services, does not garner much enthusiasm when quality is the measure. Only 29 percent of respondents agreed that the quality of banking service they receive is excellent or very good⁵⁰ (Exhibit 6 - 32). Recent newspaper articles contain many complaints about the service levels, bureaucracy, and mistakes made by banks. A review of these articles suggests that the quality of service complaints derive from mistakes in daily interactions and are not complaints about fundamental problems. Common complaints include branch waiting time, no single point of contact, lack of expertise among branch-level employees, and lack of staff flexibility.⁵¹ Although these might not seem like major issues, it is these little mistakes that are remembered and retold. Banking is a unique business in that each customer interaction does not result in significant revenue, and yet consumers have many more transactional interactions with their financial institution than with other service providers. Hence, there are more opportunities for mistakes and negative customer experiences.

That said, bank satisfaction ratings are actually quite high. In 1997, 91 percent of bank users surveyed said they were moderately or highly satisfied with their bank. The number saying they are highly satisfied, however, has decreased from 48 percent in 1986 to 43 percent in 1997 (Exhibit 6 - 33). Moreover, consumers appear loyal to their institutions. In the past 5 years, 66 percent of respondents have not switched institutions (Exhibit 6 - 34). However, these results may also be an indicator of consumers' views on their choice of providers and the available alternatives to their current institution or the lack thereof.

Safety and soundness are additional aspects of quality that Canadians find important. In general, Canadian banks are considered safe and stable,⁵² and Canada's history of stable organizations supports consumers' perspectives. In the past 15 years, only 4 banks⁵³ and 37 financial

⁵⁰ Yankelovich Monitor 1996, extensive US consumer behavioural survey.

⁵¹ Literature searches.

⁵² Consumers Association of Canada, literature searches.

⁵³ Canadian banks that have failed: Canadian Commercial Bank, Northland Bank, Bank of British Columbia, and Bank of Credit and Commerce.

institutions in total have failed in Canada, at an estimated cost to the Canadian Deposit Insurance Corporation (CDIC) of \$3.1 billion. In the same period, over 1,563 banks and 5,182 financial institutions in total failed in the United States, at an estimated cost of US \$192.1 billion (Exhibit 6 – 35). Risk specialists also assess Canadian banks as having very good risk profiles. On average, Canadian banks garner a “B” Financial Strength Rating⁵⁴ from Moody’s Investor Service, which is the second highest rating among selected countries (Exhibit 6 – 36).

Consumers also benefit from Canada’s regulatory system, which provides safeguards for basic privacy and security. An example is Canada’s compensation scheme. Like most countries, Canada offers deposit protection under a compulsory system administered by a government agency (the CDIC). At \$60,000 per depositor per institution, Canada’s deposit insurance coverage is average compared with that of other countries (Exhibit 6 – 37).

Another aspect of quality is the efficiency of the Canadian payments system, which is viewed as an efficient model by other countries.⁵⁵ Cheques ordinarily clear within 1 day, whereas they might take anywhere between 1 and 5 days in other countries (Exhibit 6 – 38). Increasingly, however, cheques are becoming an outmoded form of payment. Thus, a comparison on the basis of days to clear cheques becomes almost irrelevant – especially for European countries, where cheques are no longer used extensively. Hence, it can be said that Canada is very efficient in an old technology. However, as Canadians move to electronic payment methods, the efficiency of the banking system will improve as there is a correlation between banking system costs and the number of cheques cleared through the system.

Despite their many strengths and weaknesses, Canadian banks have tried to improve their quality of service and become more customer-focused. However, like any large organization, it is difficult to change the corporate culture and disseminate attitudes among all staff. Doing so requires instilling a true performance ethic by linking each employee’s personal success to the success of the change program. Change is that much more difficult given banks’ historical mix of decentralized branch management and centralized product groups. Service gaps often exist at the intersection of distribution and product development (e.g., branch staff being unaware of product group service offerings and product groups being out of touch with branch-level issues).

Canadian banks are also hindered by legacy systems in information technology. However, efforts have been made to move to a more customer-focused technology architecture from a product-focused one. Although Canadian banks are further ahead than similar-sized US banks in this area, they are still behind new non-bank competitors in effectively using information technology to the maximum benefit of consumers and themselves.

The banks have allocated and are continuing to allocate resources and senior management time toward improving quality and service levels. High levels of customer satisfaction can lead to customer loyalty, which has positive economic benefits on both the revenue side, in terms of cross-selling opportunities, and the cost side, in terms of reduced customer acquisition costs.

⁵⁴ Financial Strength Rating (FSR): Moody’s rating of an institution’s intrinsic safety and soundness on a stand-alone basis.

⁵⁵ Bank of International Settlements.

Choice. Canadian financial institutions offer a wide range of products and services to their customers (Exhibit 6 – 39). In fact, the breadth and depth of the Canadian banks' product offering is at par with that of US banks. Choice in traditional products is well-developed; however, there are variations in certain product categories. For example, Americans have a greater choice in long-term mortgage options, but Canadian consumers had the option of variable rate and open mortgages much earlier.

Overall, Canadians have a good selection of financial products and services from which to choose. For the most part, Canadians can obtain these products and services from a full range of providers now that regulatory barriers have generally come down. Banks, however, are not permitted to sell insurance through their branch networks. By comparison, most developed countries today permit banks to compete directly with insurance companies, including allowing them to sell insurance in their branches. Nevertheless, Canadians have many other channels to choose from when purchasing insurance including direct mail, telephone, and the Internet.

Canadian institutions are also keeping pace with other countries' banks in terms of technology-based products. Canada Trust's web site was named the best among foreign banks in the United States, and three Canadian banks are listed in the top 10 home banking services in North America (Exhibit 6 – 40). Canadian banks have been particularly successful in online banking, and Canadian consumers have full choice in electronic banking channels such as telephone, PC, Internet, and ABMs.

Canadians do not have the same number of providers as in the United States, which limits consumers' choices. The non-bank sector is much more developed in the United States, thus expanding both the range of providers and the products and services available to consumers. The US credit card market is a good example of how new competition, such as monoline providers, has affected competitive dynamics and resulted in improved price, choice, and service to consumers. Americans have a far greater choice in the types of credit cards, fee options, interest rates, loyalty programs, and payment options available to them.

A final element of choice is the adequacy of information that is available to help consumers make comparisons and decisions. We have already seen that consumers are not satisfied with the information they receive regarding service charges. Therefore, regulators must work in conjunction with institutions to ensure consumers are adequately informed and protected by establishing disclosure rules and guidelines. The transparency of information is critical given the asymmetry of information between consumers and institutions, the lack of consumer sophistication, and the potential for personal financial disaster should something go wrong.

Accessibility. Distribution and availability are the two major components of accessibility. Canadian banks have excellent distribution networks (Exhibit 6 – 41): compared to other major industrial countries, Canada has the second highest branch density at 2.72 branches per 10,000 inhabitants, the sixth highest number of banking machines at 6.17 per 10,000 inhabitants, and the third highest number of point-of-sale terminals. Points of access are increasing further with new strategic alliances between Canadian banks and retailers (e.g., TD Bank and Wal-Mart, CIBC and Loblaw's). Moreover, consumers from different parts of Canada have access to the same products and services – a credit to Canada's nationwide banking system. This history of a national banking

system has put Canada ahead of other countries, such as the United States, in providing broad distribution and access.

In addition, basic banking services are widely available in Canada. Ninety-seven percent of adult Canadians have a transaction account at a financial institution.⁵⁶ A larger percentage of Canadian consumers have a transaction account than in the United States. According to "The Survey of Consumer Finances", a Federal Reserve study,⁵⁷ 87 percent of American families have a transaction account with a financial institution.

Looking ahead

Technological advances in the financial services industry are having a profound impact both on how financial institutions are managed and on how consumers interact with them. There are some clear benefits from the new technologies in financial services including: increased convenience with access to information and transactions 7 days a week, 24 hours a day; tailored offerings; easier comparison shopping; increased speed of transactions; and the ability to have control over and self-direct personal financial planning. New technologies will enhance service levels and should eventually result in lower costs for consumers. However, technological advances also bring some consumer concerns about privacy, security, fraud, and complexity and inaccuracy of information. Regulators around the world are struggling to develop the appropriate regulatory framework for this new technology and establish an appropriate balance between caveat emptor and consumer protection.

Technology has also enabled new entrants to enter the Canadian market and provide increased competition to incumbents. For example, Citizens Bank and ING Direct, both branchless banks, offer consumers low or no-service-charge savings accounts and higher rates of interest. The Loblaw's-CIBC alliance is also advertising no-service-charge accounts. As described in Chapter 5, some US providers have also recently entered or announced plans to enter the Canadian market (e.g., MBNA, Capital One, Countrywide). These monoline providers will increase the choices available to consumers, and the elimination of foreign branch restrictions will give consumers even greater access to foreign providers. It is too early to determine the success rates of these providers and whether they will be able to effectively penetrate the incumbents' vast customer franchises. Customers, however, are becoming less receptive to the concept of one-stop financial services shopping,⁵⁸ which suggests that they will be open to these new competitors.

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⁵⁶ Report to Industry Canada by Association coopérative d'économie familiale du Centre de Montréal.

⁵⁷ *The Survey of Consumer Finances*, Federal Reserve Board, 1992.

⁵⁸ Goldfarb Report, 1997.

Negative consumer perceptions of banks are not a uniquely Canadian issue. Banks have come under attack in the United Kingdom and Australia and do not achieve good ratings for quality of service in the United States or the Netherlands (exhibits 6 – 42, 6 – 43). To reduce negative perceptions in Canada, the banks face a two-part challenge: they must fill service gaps to better meet the needs of Canadian customers, and they must promote those areas where they perform well on a comparative basis but where they are perceived negatively.

7. Examining International Regulations

A strong, efficient, and competitive national financial system is a commonly accepted “public good” and a vital element in a growing domestic economy. As businesses and consumers face the challenges and opportunities in the rapidly evolving global marketplace, a strong financial system is becoming increasingly important in both developed and emerging markets.

Underpinning a nation’s economy is a financial system that comprises a variety of institutions that must be strong, efficient, and competitive themselves. Overseeing this system is a regulatory framework that aims to maintain a strong, stable financial system that meets the needs of its constituents. This framework can be divided into three areas: (1) prudential regulation, which dictates that financial services providers operate in a safe and sound manner; (2) competition regulation, which ensures that providers of financial services observe proper market conduct; and (3) consumer protection which sets out rules that protect the retail customer (Exhibit 7 – 1).

Not surprisingly, the forces affecting the global financial services market present significant challenges for national policy-makers and regulators. Although each nation has a different starting point, legacy, and evolutionary path, their responses to these forces provide interesting perspectives for Canadian regulators. Correspondingly, this final chapter explores the evolutionary trends in regulation, national policy goals, competitiveness policy decisions, and the balancing of stakeholders’ objectives.

Evolutionary Trends in Regulation

The rationale for regulation is quite simple. Every stakeholder needs the protection of some basic rules, regardless of whether they are set by government sanction or left to the discipline of the competitive marketplace. Governments must balance this need for protection and stability against the need to promote economic growth and market efficiency. For example, regulatory costs must be weighed against the need for ongoing productivity improvements necessary for financial institutions to remain competitive.

Financial services regulations have changed over time. While the timing of the changes has varied across countries, a common evolutionary pattern is evident. A review of the past 30 years indicates that there have been three distinct stages of evolution (Exhibit 7 – 2).

- **Stage 1: Deregulation of domestic markets.** The first stage (1970s to early 1980s) saw the complete breakdown of protectionist, national controls on competition and the subsequent opening of domestic markets where governments removed controls and restrictions on loans and deposit rates (e.g., liberalized fixed commission rates) and reduced influence over credit allocation (e.g., directed credit to the housing industry through tax incentives). This action usually followed periods of high inflation, resulting high interest rates, and disintermediation.

This easing of quantitative, interest rate, and price restrictions was typically a reaction to powerful forces of change. History and experience show that such artificial constraints cannot withstand the collective decision of millions of customers. None of the major industrialized countries retains rate controls or other noticeable constraints on lending. Compulsory investment requirements are rare and of limited significance. Governments have drastically reduced requirements and all but eliminated controls on foreign exchange and international transactions.

- **Stage 2: Increased reliance on market mechanisms.** The second stage of evolution (late 1980s to 1990s) is still occurring in most developed countries. This stage has seen an increased reliance on market mechanisms such as competition. Line of business restrictions, for example, have been reduced, permitting companies to put together combinations of products to serve customers with new value propositions (Exhibit 7 – 3). Moreover, liberalization of market access has brought new formidable competitive players. The recent and accelerating consolidation of US banks after the removal of barriers to nationwide banking, the convergence of these same banks with other financial services companies (e.g., securities firms and finance companies), and Canada's removal of the barriers between its four traditional pillars exemplify this second phase of regulatory evolution.
- **Stage 3: Global market model.** The third stage of more global regulatory change (late 1990s) is just starting and will continue into the next century. Markets are increasingly operating without regard to national boundaries – a phenomenon being driven by global financial institutions. These agents have expert knowledge of individual country differences and, consequently, are able to operate across boundaries – seamlessly competing as “locals” while still capturing global scale and specialization advantages. For example, the large US investment banks – most of which also operate in Canada today – dominate worldwide, with many new European combinations seeking to challenge them. Meanwhile, in retail, banks such as Citibank, Hongkong Shanghai Bank, ABN Amro, and others are seeking to build truly global retail franchises or at least strong hemispheric ones.

As the world globalizes and financial companies continue to cross national boundaries, national regulators face regulatory challenges for those providers in their countries that aspire to become regional, hemispheric, or global competitors. This trend toward increased globalization is forcing increased harmonization and cooperation among national regulators as they search for ways to effectively supervise cross-border conglomerates.

For example, the European nations are transitioning to a full common market for financial services and the first truly European currency, the Euro. In addition, the World Trade Organization (WTO) has just completed a major round of financial service negotiations, which locks countries into their individual financial reform commitments. Canada's WTO commitment was its newly changed policy on foreign bank access and branching. International regulatory bodies, like the Bank for International Settlements (BIS), and private sector groups, like the Group of 30 (G-30) and the Institute of International Finance (IIF), are also actively evaluating

these new supervisory and competitive issues affecting the delivery of financial services around the world.

National Policy Goals

In looking at several selected countries, there appear to be a number of commonalities in regulators' attempts to strike a proper balance between preventing market failure and allowing financial markets to serve their customers efficiently. These broad similarities in national policy intent flow from the need to have strong, stable financial markets. The recurring themes found in most countries are: promoting fair and orderly markets to support real economic growth; ensuring the safe and sound operation of financial institutions to support overall stability; and protecting consumer interests through information transparency and various government guarantees.

Important distinctions in national goals surface, however, when individual countries are plotted along two related measures: the degree of open competition and the degree of government promotion of national and global champions (Exhibit 7 – 4). Countries in the top left of Exhibit 7 – 4 have fully embraced the benefits of competition and yet have taken a neutral position with respect to individual institutions. Countries in the top right of the exhibit, on the other hand, have fully embraced open competition but have chosen as a matter of national interest to promote and support individual institutions as potential long-term national and global winners.

In setting their national financial policies, countries therefore have several distinct options with respect to how they position their financial system competitively: they can choose to be competitively neutral; they can promote national or global champions; or they can follow a middle path. A financial institution's success depends on a variety of inputs, but government policy can be a critical environmental factor.

Option 1: Maintain competitive neutrality

Countries such as the United States and the United Kingdom, are completely open and neutral toward competition in their financial industry. This policy includes “national” treatment for all foreign competitors; that is, foreign financial institutions are given the same rights, responsibilities, and consideration as a country's domestic financial institutions.

United States. In the United States, there is no explicit or implicit policy that promotes one set of financial institutions over another or that chooses individual winners to promote the national interest. These decisions are left to the natural selection process of the marketplace. Given the fragmented nature of the US financial system, no set of institutions has yet emerged to dominate the industry, though many are in the process of building truly national platforms to serve their customers more effectively and become national and global champions. This contest includes both bank and non-bank financial services providers.

Starting from a neutral national policy position, some US investment banks are among the strongest in the world. They have achieved this market strength despite outmoded restrictions in

US law (i.e., the 1933 Glass-Steagall Act) that impede corporate governance and structural freedom by continuing to limit the combination of investment and commercial banking in the same legal entity.

Moreover, the US International Banking Act of 1979 guarantees foreign banks operating in the United States full national treatment, with domestic banks operating under either national or state bank charters.⁵⁹ Furthermore, there are no size restrictions on US acquisitions. While no foreign bank has yet acquired a major US bank, that possibility certainly exists given the current surge in consolidations worldwide. Existing US law and policy would not preclude that kind of acquisition, although a domestic public policy debate would likely ensue. Assuming that the foreign bank met all the US requirements in terms of prudential and competitive regulations, no legal or policy reason would exist for regulators to deny the acquisition based on current law.

Today, hundreds of foreign banks collectively account for roughly 24 percent of all US banking assets, though no single foreign bank has yet achieved a significant market position. Even ABN Amro, the largest foreign bank in the United States, is not among the top 25 banks in that market.

United Kingdom. The United Kingdom has a long-standing policy of open competition and freedom of entry for foreign institutions, which is based on a steady deregulatory trend over time and a bias toward open operating environments. The country has taken the position that financial regulators should not impede competitiveness but should instead provide a level playing field for all types of financial institutions by gradually reducing competitive barriers over time.

From the UK perspective, the marketplace is the best supervisor of essential regulatory issues: competitiveness, consolidation among financial institutions, and service to customers. In this context, the United Kingdom has few restrictions on entry. Like all other industries, the financial services industry is governed under the UK Competition Act. The main entry test is whether the new financial services entrant is “fit and proper,” regardless of nationality.

One of the effects of this policy is the disappearance of significant domestic investment banks. Foreign firms have acquired all major domestic providers in recent years. Almost 40 percent of UK bank assets are foreign-owned, yet they hold a mere 20 percent of deposits and an even smaller share (10 percent) of consumer credit.⁶⁰ Strong domestic banks flourish side by side with their foreign competitors. Market leader Lloyds TSB, for example, is a domestic success story in this highly competitive marketplace.

The United Kingdom recently reaffirmed its open competitive markets policy with the establishment of its new super-regulator, the Financial Services Authority (FSA). As part of a reorganization of the UK financial services regulatory sector, the FSA has become the single

⁵⁹ National treatment can mean that certain operating restrictions are still in place. For example, like domestic banks, foreign banks that want to engage in the business of gathering retail deposits in the United States must first set up a bank subsidiary to do so (e.g., Bank of Montreal’s Harris Bank); foreign banks that operate through a branch-only structure may not take retail deposits.

⁶⁰ Bank of England Monthly Monetary Statistics.

regulator of all financial services.⁶¹ Its aims are to protect financial services consumers, promote clean and orderly markets, and maintain confidence in the financial system. As part of the second component of its mission, the FSA will “promote fairness, transparency, and orderly conduct in financial markets – looking initially to the markets and market participants to set and enforce high standards in this area.” This mandate for competitive markets is what drives the United Kingdom’s decision to remain completely neutral, not favouring one set of providers over another.

Other countries. Often, a country’s shift in national policy to more open markets is forced by a major economic crisis. For example, Argentina’s economic collapse in the early 1990s forced it to completely revamp its financial regulation system and restructure the industry from the top down. Before the crisis, 94 percent of Argentina’s top bank assets were domestically owned; now, domestic banks account for only 60 percent of the current total. In Venezuela, the story is similar. Before that country’s crisis, 92 percent of top bank assets were domestically owned; by 1997, the percentage had fallen to 48 percent (Exhibit 7 – 5). As these examples show, national policy must confront not only the timing of market reform but also its probable impact on the resulting industry structure and the most likely endgame scenario. If countries do not get their public policy frameworks right from their national perspectives, they may foreclose attractive options in the future that could help strengthen their financial system or make real contributions to economic activity.

Other countries have experienced even greater economic upheavals due to market forces (e.g., currency collapse, directed government lending, and subsequent debt overhang). As a result, they have seen a dramatic shift in the mix of local and foreign players, since foreign competitors are often part of the solution to the problem of attracting new capital and new business practices. Much of Asia is currently in the midst of this kind of competitive paradigm shift that usually occurs only once in a lifetime. These countries will face similar choices: how far to open their markets to foreign competition and whether to remain competitively neutral or promote national champions as their markets reform and consolidate.

Option 2: Promote national and global champions

Other countries, such as the Netherlands, Switzerland, and Spain, have taken either a leading role or a behind-the-scenes position to ensure that strong national and globally competitive financial institutions emerge. The Dutch, for example, have two large global players (ING Barings and ABN Amro), as do the Swiss (United Bank of Switzerland and Credit Suisse First Boston). In both cases, extensive and close public- and private-sector cooperation appear to ensure that strong, global players emerge to serve the needs of both domestic and foreign customers on the world stage.

The Netherlands. Like the Swiss, the Dutch consider financial services to be a strategic national industry that is in their national interest to promote. Prior to the 1990s, the Netherlands was

⁶¹ The Bank of England retains its role for the conduct of monetary policy and overall financial stability in the United Kingdom.

thought to be overbanked under an official banking cartel. However, with financial market changes occurring within the European Union, the Netherlands realized that such a system was not sustainable given forces like globalization and technology advances. As a result, it moved to a policy of promoting national champions that would in turn promote Dutch business and trading interests around the world. While there was no explicit legal change to promote individual national or global winners, the regulators used their discretionary powers within the domestic policy context to encourage strong players to consolidate their positions. The frontrunners were able to do so with the full support of their national supervisors, who worked with them to ensure that they had a strong national regulatory system that would serve as a foundation for their national, regional, and global aspirations. At the same time, the Netherlands opened up its domestic financial system in line with the broader European mandate, eliminating the remaining major restrictions on ownership and business powers.

While the Netherlands' domestic market is now highly concentrated, with the top five players controlling almost 75 percent of domestic banking assets, this level of concentration is viewed as being of secondary importance compared to the national objective of promoting globally-focused competitors. National players like ABN Amro and ING Barings now use their domestic strength and supporting regulatory platform to compete in international markets. At home, retail customers benefit from an efficient system, especially in payments where the Netherlands has achieved world-class productivity. A recent study by the McKinsey Global Institute, for example, found that the Dutch PFS sector was 1.5 to 2.0 times more productive than the PFS sectors in the United States, Germany, and France.⁶²

Spain. Spain is another country that has proactively promoted national financial champions. In part, this position stems from concerns about credit problems and bankruptcies in the past and the need to have healthy, competitive financial services providers in the future.

Spain has taken several actions in pursuit of this goal. First, most financial institutions owned by the national government have been privatized. Second, it merged its mortgage bank, foreign trade bank, and other specialty banks into the Bank Argentaria and then privatized the bank. Third, it put Spanish savings banks, many owned by regional governments, on a more level competitive playing field with other private banks, regulating and supervising them the same as all other private banks. This privatization effort continues.

As well, the government also encourages Spanish banks to consolidate into larger, stronger entities. The Bank of Spain offers its advice privately and publicly through periodic disclosures and statements about the direction of the Spanish financial institutions policy. When problem banks arise and head toward bankruptcy, the Bank of Spain steps in with a public announcement

⁶² McKinsey Global Institute, *Boosting Dutch Economic Performance*, September 1997. The work of McKinsey's Global Institute indicates that productivity growth is a key determinant of GDP growth. More efficient use of resources to create value allows the economy to provide lower cost goods and services relative to the income of domestic consumers and to compete for customers in international markets. This action, in turn, will raise the nation's living standards and start a virtuous cycle. (Productivity reflects the efficiency with which resources are used to create value in the marketplace. In retail banking, it is measured by computing the ratio of physical output to labor input. No comparable study has been conducted in Canada.)

about the current position of the bank and then takes the appropriate steps to resolve the situation (e.g., arranges a sale at a private auction). The government also gives fiscal incentives to encourage banks to merge and consolidate into strong national players. All of these steps have been taken to ensure the emergence and continuation of national winners that can withstand credit problems in the future more easily than in the fragmented system of the past.

Option 3: Follow a middle road

Countries such as Australia have chosen a middle road, balancing the need to have open competition and sizeable players on the global financial stage with the desire to maintain national sovereignty over winning domestic providers. After conducting a review and analysis of the financial services landscape, Australia's 1997 Financial System Inquiry (FSI) recognized that competition was emerging from outside its traditional domestic financial services markets, as well as from overseas. The principal aim of the Inquiry was to achieve a more competitive and efficient financial system. The Inquiry believed such a system would have several benefits:

- More neutral regulatory treatment of competitors from different institutional sectors would encourage those companies that are most efficient.
- Reduced barriers to entry would promote more contestable, competitive markets.
- Regulatory arrangements, which are more responsive to market changes, would facilitate innovation and bring new competitive business entrants.
- More cost-effective conduct and disclosure regulation would lower overall costs for customers and promote competition.

To this end, the Inquiry reaffirmed that Australia's competition law (Trade Practices Act) should apply to financial services just as it does to all other industries to ensure that there is no lessening of competition. It also recommended that Australia's "four pillars" policy – which imposes a government prohibition on mergers among the four largest banks – should be removed.⁶³ This recommendation was not immediately accepted by Australia's government but is currently under review.

The Inquiry also went so far as to recommend that the long-held policy prohibiting foreign takeover of any of the four major banks be explicitly removed⁶⁴ and replaced with a policy that requires all foreign acquisitions to be assessed by the underlying competition law.⁶⁵ Currently, the rules and regulations of the foreign investment board apply to all industries without exception. The Inquiry further qualified this position in its final report, stating: "The Inquiry believes that a large-scale transfer of ownership of the financial system to foreign hands should be considered contrary to the national interest. However, this does not preclude some increase in

⁶³ Financial System Inquiry, Recommendation 83.

⁶⁴ Financial System Inquiry, Recommendation 85.

⁶⁵ Foreign Acquisitions and Takeover Act of 1975.

foreign ownership of aspects of the Australian financial system, including its major participants.” The report did not quantify what constitutes a “large-scale transfer of ownership.”

After receiving the FSI report, however, the government reaffirmed its current policy of not allowing either mergers among Australia’s four largest banks or foreign acquisition of these banks pending further review and consideration. Nevertheless, a foreign company acquired one of the country’s two largest insurance providers when a domestic acquirer could not be found for the failing company.

Implications for Canada

When assessed within the context of what other countries have done on financial regulation, Canada has some obvious choices to consider about its own national financial policy. It can choose where and how to position itself on this competitive policy matrix, just as it can control “how” and “how fast” it should move toward a potentially more attractive position to ensure that Canadians are well-served.

Competitiveness Policy Decisions

Regulatory policy affects not only how and where customers are served but also how financial institutions compete against one another. This section examines the regulatory policies across the financial services landscape in terms of pricing of products and services, consumer protection, corporate structure, ownership, consolidation, and business line powers.

Pricing of products and services

Price controls have been used in some countries either to protect markets (as in the United States, where an interest rate differential once promoted certain types of financial institutions for house financing) or to ensure favourable prices (as with usury ceilings that artificially limit interest rates for all types of credit finance). Over time, however, most countries have historically discredited such artificial pricing restrictions after their initial imposition because they ultimately restrict the flow and amount of capital and credit, particularly during times of high inflation, corresponding interest rates, and disintermediation.

As is the case in most developed countries, financial institutions operating in Canada are free to compete on price. Canada places no restrictions on the pricing of either assets (such as loans to consumers) or liabilities (such as deposits). Pricing is directly determined by competition in the marketplace, both domestic and foreign.

Consumer protection

Regulations, rules, and guidelines are established to protect consumer privacy and to provide access to information and recourse if problems occur. The formality and administration of these regulations varies among countries: some rules are formally entrenched in regulation, while others are market-regulated. The importance and emphasis on consumer protection also varies by

country. For example, in the United Kingdom, the Data Protection Act governs privacy with entrenched formal regulation, and are rigorously overseen by the new FSA. Conversely, recourse rules generally are administered by an ombudsman and regulators typically do not get involved. At the other end of the spectrum, Japan has no regulations for data protection held by private organizations. Similarly, in the Netherlands, much of the onus is on the consumer if something goes wrong.

Corporate structure

Models of corporate structure vary from institution to institution and from country to country (Exhibit 7 – 6). Financial products and services are accessed by customers in one of three main ways:

- **One financial institution offers all financial services and products directly to its customers.** Following this universal bank model, banks in Austria, Germany, Italy, Luxembourg, Portugal, Spain, and the United Kingdom can offer securities and insurance products directly to customers.
- **Parent Company offers some financial services, while subsidiaries offer other products and services.** Most countries, including Canada, allow financial institutions to sell financial products and services to consumers directly through the financial institution itself or through a subsidiary. A common pattern is for financial institutions to offer their traditional products directly and to offer new products through subsidiaries. This appears to be the preferred operating model in much of the developed world.

For example, banks typically offer chequing accounts, savings accounts, and loans directly, while insurance companies offer life, investment, and protection products. To enter a new but related business line, a bank may work through a subsidiary, such as a securities firm or an insurance company. Establishing a subsidiary is often required to protect banks from “potential contagion” by non-bank products (such as securities) that could negatively affect governmental guarantees of deposit protection to bank customers (Exhibit 7 – 7). This is true for most developed countries such as Canada and most of continental Europe.

- **Affiliates of a holding company offer all financial services.** This approach delivers products and services to customers through a holding company that owns both bank and non-bank affiliates (Exhibit 7 – 8). This approach is permitted and widely used in countries such as the United States, the Netherlands, and Italy. In others, it is permitted but used infrequently. In certain other countries, such as Canada, Greece, Luxembourg, and Sweden, this approach is not permitted at all.

At least two forms of financial services holding companies have emerged. In the United States, for example, both a traditional commercial bank holding company and a new PFS or retail bank holding company have evolved. In 1956, the traditional bank holding company was authorized – under a commercial banking charter – as an alternative form of corporate structure, primarily to engage in the limited interstate banking opportunities

available at that time. Since 1970, these traditional bank holding companies have had to meet product, activity, and acquisition restrictions intended to ensure they provide only those services deemed “closely related to banking.”⁶⁶ Many commercial banks in the United States chose this form of corporate structure to gain access to the emerging geographic and product opportunities outside their normal banking license.

Another form of bank holding company has emerged recently in the United States – one designed especially for the delivery of personal financial services. Companies such as USAA, GE Capital, American Express, Travelers Group, Merrill Lynch, Fidelity Investments, Morgan Stanley, Edward D. Jones, State Farm Insurance, and many other securities and insurance firms are acquiring still different types of US banking charters. They operate either as federal savings banks (a newly liberalized retail banking license) or as industrial loan companies (which function like state-chartered commercial banks that do not belong to the Federal Reserve System).

These new financial services holding companies have no restrictions on the competitive products or services they can provide to their customers or on what organizations they can acquire or merge with. Unlike traditional commercial bank holding companies that are regulated by the Federal Reserve, these companies are “regulated” only by the marketplace (operating under the normal corporate disclosure rules set by the US Securities and Exchange Commission for all companies). Thus, these new financial holding companies are subject to all the rewards and punishments of competitive markets.

Given the difficulty of isolating corporate structure models from other variables, it is impossible to determine which one of these corporate structures serve customers best. In all models, prudential and competitive rules can be constructed to serve customers from a market perspective and still meet legitimate public policy concerns.

Ownership

Another dimension of bank governance is the matter of ownership (Exhibit 7 – 9). Historically, public policy in this area has reflected concerns over the potential for the concentration of economic power and the use of cartel-like controls over both retail and business customers. However, these concerns are less relevant today given increasing globalization, the liberalization of markets under the recent WTO agreement, the widespread acceptance of national treatment, and the rise of non-bank competition in most markets.

Today, ownership concerns focus more on *who* may own a bank. Many countries allow any type of company to own a bank, on the premise that such ownership helps promote competition and that any potential for abuse (e.g., insider transactions that could cause risk to the bank) is a manageable by-product of the competitive tradeoffs involved. France, Germany, the Netherlands, Portugal, Spain, Switzerland, the United Kingdom and, increasingly, the United States permit

⁶⁶ As determined by a formal vote of the Board of Governors of the Federal Reserve System, the supervisor of these traditional bank holding companies.

any company to own a bank, subject to normal supervisory reviews about specific ownership levels to ensure investor and management suitability.⁶⁷ In the United States, General Electric, for example, owns a small state chartered bank⁶⁸ that has full access to the payments system and FDIC protection. A number of US commercial and retail companies have set up limited purpose credit card banks as their way into the broader payments system.

In other cases, ownership is limited. Even countries that permit unrestricted ownership of banks by other types of companies still require a regulatory review to ensure that the bank management team and primary shareholders are “fit and proper” (e.g., Belgium, the Netherlands, the United Kingdom). In Canada, the 10 percent ownership rule applies in the case of Schedule I banks, prohibiting commercial companies, for example, from acquiring them. Similarly, Italy has an ownership limit of 15 percent, while Sweden has a limit of 50 percent – except in cases of insolvency.

Another aspect of ownership is the ability of foreign financial services providers to purchase a domestic provider or enter a country independently to serve its domestic customers. Many countries have completely eliminated restrictions on foreign ownership and granted full national treatment to foreign entrants (e.g., the United States, the United Kingdom, and the rest of the European Union countries). While members of the European Union have been able to branch freely throughout Europe since 1993 under the Second Banking Directive, individual EU members can still treat foreign branches (e.g., foreign branches of Canadian banks) differently than those of domestic European banks.⁶⁹ Canada is in the process of permitting foreign banking organizations to branch in 1998.

With respect to foreign ownership of subsidiary banks, most countries – including Canada – now provide national treatment to foreign entrants. Canada provides national treatment under its current 10 percent ownership rule for both domestic and foreign banks. This policy also applies to other parts of the Canadian financial services system, such as the insurance and securities sectors.

Not surprisingly, the opening up of domestic markets to foreign competition has resulted in varying degrees of foreign bank market penetration (Exhibit 7 – 10), as well as an increasing degree of non-resident holdings of both assets and liabilities in various countries (Exhibit 7 - 11). Again, this can be attributed to the accelerating globalization process discussed in Chapter 3, in addition to favourable domestic tax treatment and openness to foreign capital flows regardless of the domestic financial structure. In most countries where data is available, the amount of non-resident assets and liabilities is actually higher than comparable figures for foreign financial institutions. Comparable information on non-resident holdings for Canada and the United States is not available.

⁶⁷ In the United States, this is primarily limited to ownership of a retail banking charter such as a federal savings bank.

⁶⁸ A Utah industrial loan company.

⁶⁹ Branches of non-domestic banks are fully regulated by the EU member state in which they operate and are not entitled to the single EU “passport” for providing services or establishing subsidiary branches throughout the EU.

Consolidation

Financial services providers in many national markets have either already consolidated – as in the Netherlands and Switzerland – or are in the process of doing so – as in the United States (Exhibit 7 – 12). Few countries, if any, have formal, explicit restrictions on either the absolute size or the number of remaining institutions after further mergers or acquisitions. Implicitly, however, some countries appear to have informal concentration limits. Current Canadian policy, for example, does not permit the merger or acquisition of any Schedule I bank.⁷⁰ This “big shall not buy big” policy has no legislative base; however, it appears to reflect two concerns. The first is that a merger of two major players could give rise to anti-competitive behaviour; the second is that, as the traditional four pillars began to crumble in the mid-1980s, regulations deemed it important for Canadian institutions to have an opportunity to adjust to the new competitive challenges and opportunities free from the immediate threat of major new competitors that would result from the consolidation of industry leaders.

Australia is another country that currently has a stop-limit in place on mergers among its top financial institutions. Despite the Financial System Inquiry’s recommendation to dissolve Australia’s traditional “four pillars” policy, the government decided for the time being to maintain its existing policy that protects its largest institutions from mergers and acquisitions (including foreign acquisitions). This was seen as the preferred means to protect Australia’s national interests both domestically and globally.

In the United States, there are no explicit limits on consolidation other than the normal antitrust review to ensure adequate competition at the local market level. There are, in fact, numerous markets where two or three large banks compete with hundreds of smaller institutions. In California, for example, two large commercial banks – BankAmerica and Wells Fargo – compete head to head with more than 400 smaller banks and numerous non-banks for the same customer base. Along the Canadian border, US Bancorp and Norwest Bancorporation in Minneapolis compete vigorously head to head, as well as against hundreds of community banks in that region. In many local US markets, there are often only three major local providers, yet competition is still deemed adequate by the federal authorities.⁷¹ In reality, many countries have a few, large national and global players in addition to hundreds of smaller, more local players (e.g., credit unions, savings banks, and cooperative banks).

To monitor consolidation trends and the impact on local markets, most countries conduct regular competition policy reviews (e.g., Australia, the United Kingdom). Some conduct dual reviews to ensure adequate competition in the marketplace – an example is the United States, where both the Department of Justice and the federal bank regulators can review bank mergers. Canada has a

⁷⁰ This policy is currently under review by the Task Force on the Future of the Canadian Financial Services Sector. For additional information, see the *Report of the Task Force of the Canadian Financial Services Sector* in response to a request from the Secretary of State (International Financial Institutions), July 11, 1997.

⁷¹ Stephen A. Rhoades, “Consolidation of the Banking Industry and the Merger Guidelines,” *The Antitrust Bulletin*, XXXVII (Fall 1992). “The results [of the study] indicate that, under current guidelines, mergers and acquisitions could occur to the point that the largest number of banking organizations in any single market in the United States would be six, and the average number per market would be three.”

three-part review process: the Competition Bureau reviews competitive issues at the local market level; the Office of the Superintendent of Financial Institutions (OSFI) conducts a prudential review; and the Ministry of Finance conducts a final public policy review.

Business line powers

Business line powers refers to the ability of one financial institution to either affiliate with, or acquire, another financial institution. Most of the developed world has permitted the major financial industry segments – banking, securities, and insurance – to converge and combine into new entities with new value propositions. These new value propositions serve customers with a broader range of products that are manufactured internally and then distributed through a variety of channels within a common corporate structure. By allowing its four traditional financial pillars to converge, Canada has already enabled banks, securities firms, insurance companies, and trust companies to be affiliated through subsidiary arrangements.

Balancing of Stakeholders' Objectives

Regulators must be aware of the impact that regulatory change has on each respective stakeholder. For example, while consolidation may exert positive effects on financial services providers in terms of cost reductions and potential synergies, it may reduce choices for customers in the short term. Similarly, increasing the amount of competition, either through foreign entry or full reduction in business line powers, also has implications for both providers and customers. These actions may result in price declines that could have negative implications for institution profitability, shareholder returns, and system stability. Consumers, however, would benefit from enhanced choices and lower prices.

Given the differing and often conflicting objectives of the various stakeholder groups, policy-makers must evaluate their decisions to maximize stakeholder preferences and reduce trade-offs. For example, if Canadian policy-makers were to design an optimal financial system, they might adopt two key objectives: (1) to have financial services as good as the best in the world; and (2) to ensure that they do so in the context of a thriving, globally competitive Canadian economy. Each of these key objectives would have related sub-objectives. Striving for world-class financial services would involve a number of component parts that must be considered: ensuring real customer value (e.g., providing world-class services at transparent, competitive prices); offering real competition and consumer choice; providing broad access to all products and services; ensuring the safety and soundness of financial institutions; and providing basic customer protections (e.g., deposit protection, privacy). The second objective would have related parts as well: building a world-class financial infrastructure for Canadian businesses; promoting a thriving, Canadian-based financial industry; and remaining a responsible trading partner. Obviously, there would be trade-offs that must be considered, but such an approach could help provide the vision and guiding principles for the future.

Lessons from other industries may also prove insightful. In deregulating and consolidating industries, for example, prices typically fell by roughly 20 percent in the first 5 years after deregulation and by another 20 percent over the next 5 years.⁷² The telecommunications industry in the United States and Canada, for example, has undergone significant competitive changes since deregulation. In the United States, AT&T – the traditional supplier of long-distance calling services – suffered when equal access to long-distance phone lines was granted to competitors in 1984. Although it quickly adjusted to competitors' price formulas, AT&T lost 9 percent in market share in the 3 years following that market's deregulation.⁷³ In Canada, Stentor – the Canadian telecom monopoly – lost an estimated 20 percent of its long-distance market share in the 3 years following that market's deregulation (Exhibit 7 – 13). Financial services pricing is likely to follow a similar path, and regulators must be aware of these potential changes and their effect on different stakeholders.

* * *

While countries have followed different evolutionary paths in the regulation of financial institutions, most of the developed world – including Canada – has entered the third phase of a fully open, global financial marketplace. Most countries now have policies that are well advanced along the dimensions of prudential regulation, competition, and protection of retail customers. Although they vary in how they use their domestic regulatory environments to promote national financial services policy goals, most countries are giving serious thought to how their regulations should evolve to meet growing domestic and global demands. Rules with respect to pricing, consumer protection, corporate structure, ownership, and consolidation of financial institutions also vary by country, and a variety of models appear to be workable. Finally, lowered business line restrictions are enabling new combinations of financial institutions, which is providing full accessibility to customers in most parts of the developed world.

Given the complexities of this rapidly evolving global marketplace, both policy-makers and regulators face the daunting task of protecting and strengthening their domestic financial services environments – and doing so with the interests of multiple stakeholder groups in mind.

⁷² Robert Crandall and Jerry Ellig, *Economic Deregulation and Customer Choice: Lessons for the electric industry*, Center for Market Processes, 1997.

⁷³ Center for Market Processes, 1997.

Chapter 2 Exhibits



Canada's size

Industry players

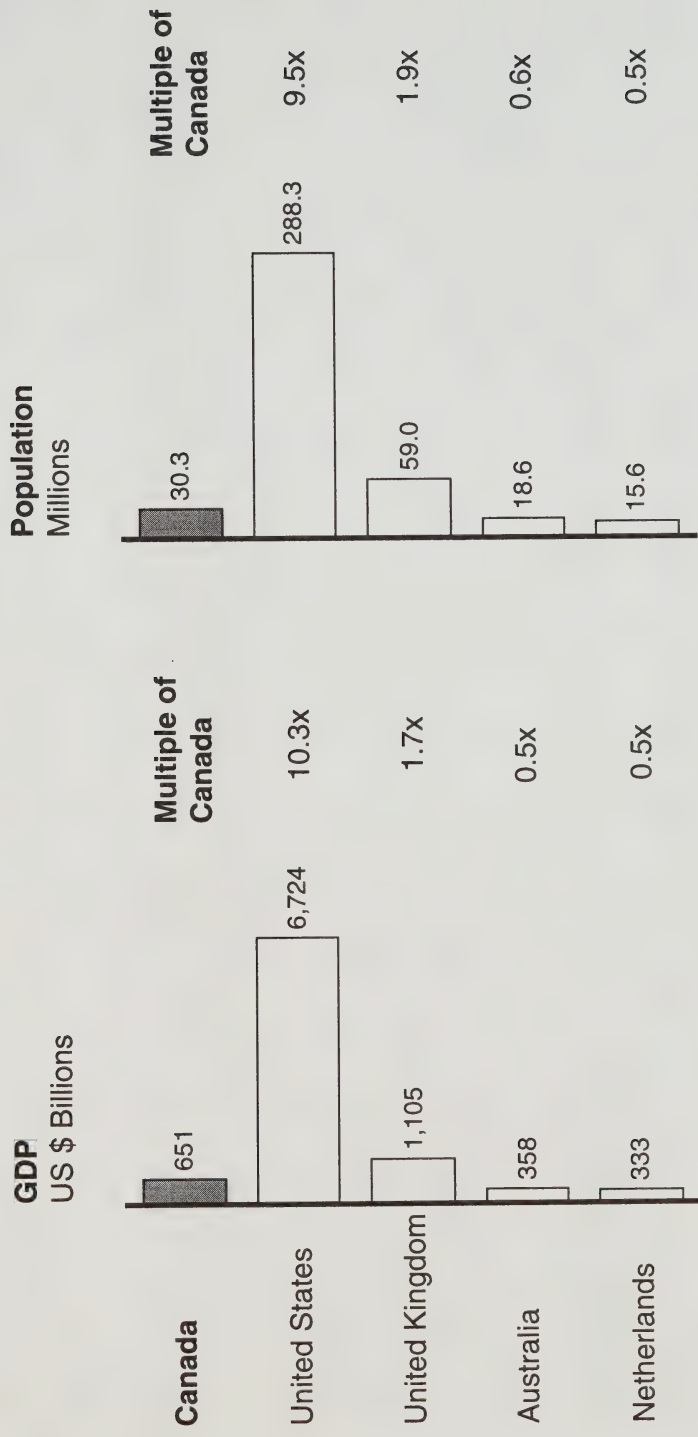
Business lines

Canadian performance indicators

International comparisons

CANADA IS A SMALL COUNTRY IN THE GLOBAL CONTEXT

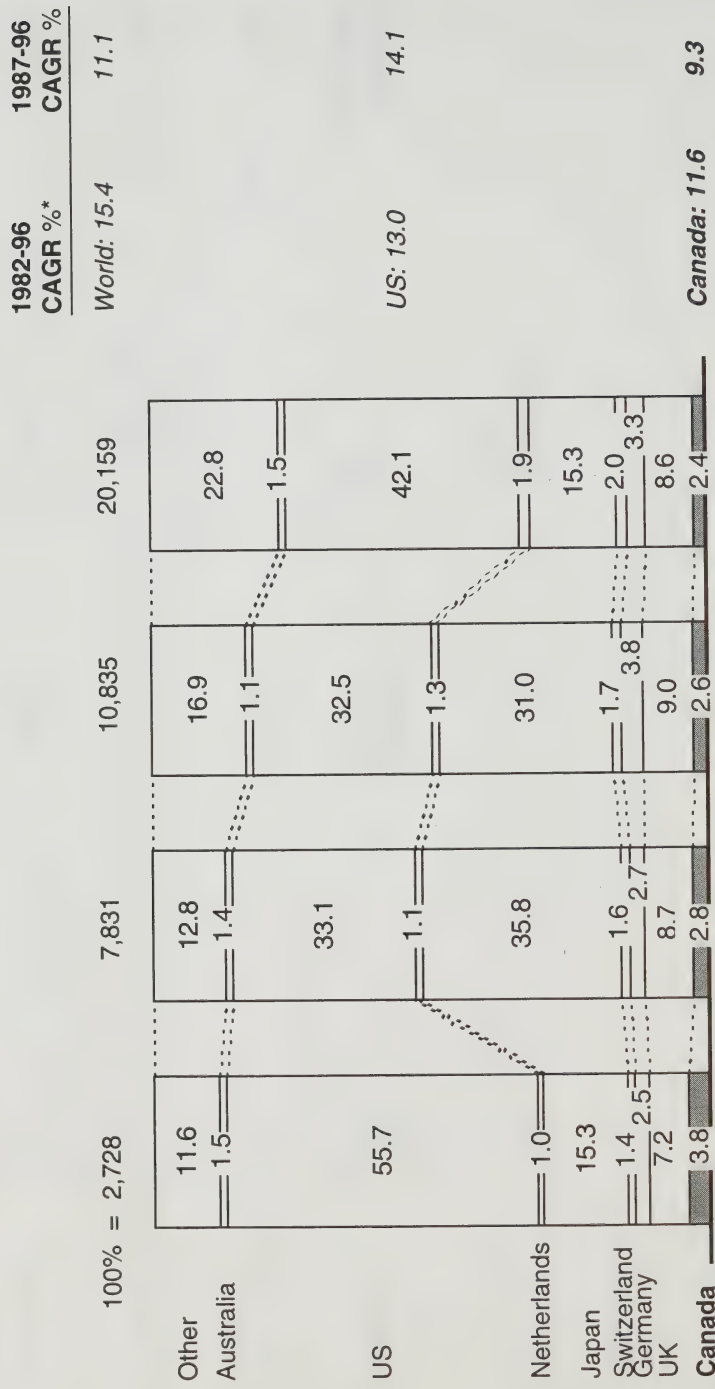
1997



CANADA'S SHARE OF GLOBAL EQUITY MARKET CAPITALIZATION IS SMALL

Equity market capitalization

US \$ Billions, percent

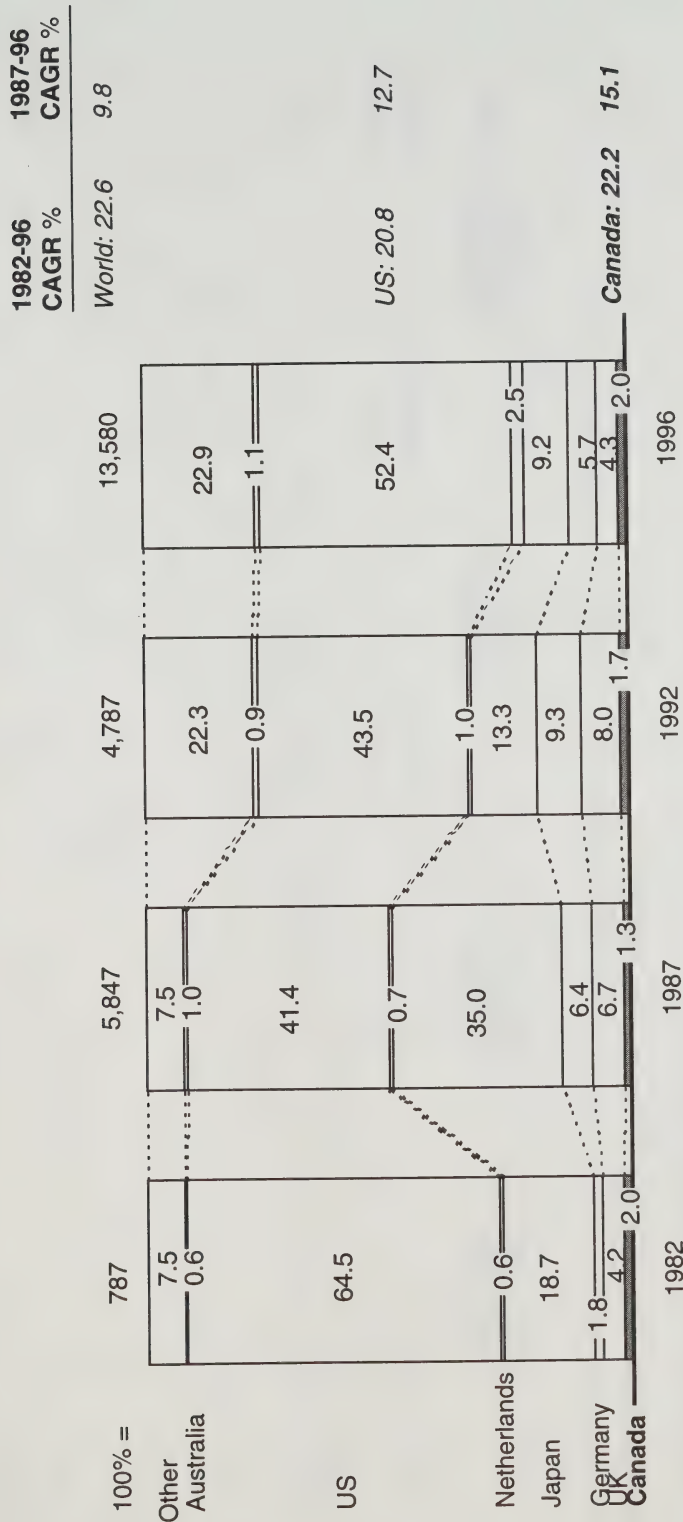


* Compound annual growth rate (CAGR) – see Appendix for Glossary of Terms

CANADIAN EXCHANGES ARE ALSO COMPARATIVELY SMALL

Value of shares traded

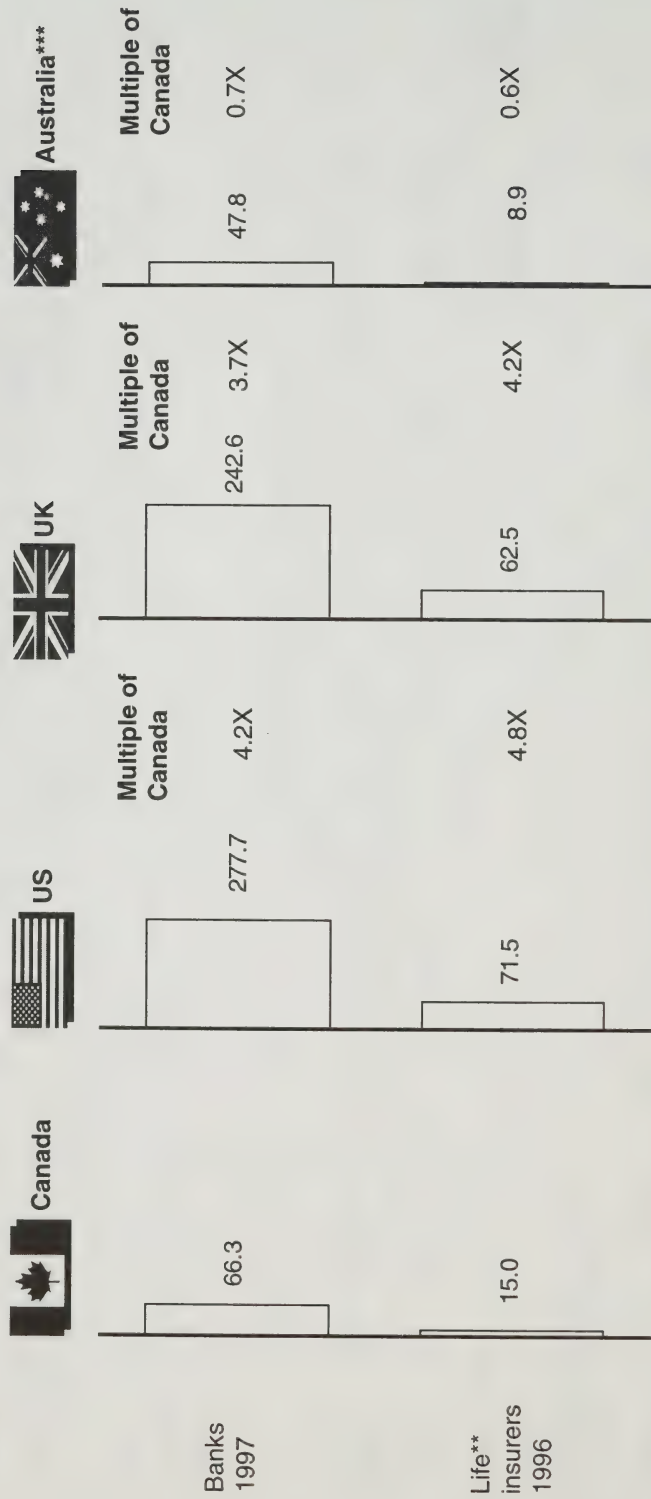
US \$ Billions, percent



THE MARKET VALUE OF CANADA'S TOP 6 BANKS AND LIFE INSURERS IS SMALL IN COMPARISON TO OTHER COUNTRIES'

Market capitalization of Top 6 financial institutions*

US \$ Billions, percent



* Top 6 ranking based on 1996 assets

** Mutual life insurers market capitalization based on average price earnings multiples

*** Represents only 5 banks and 2 insurance companies

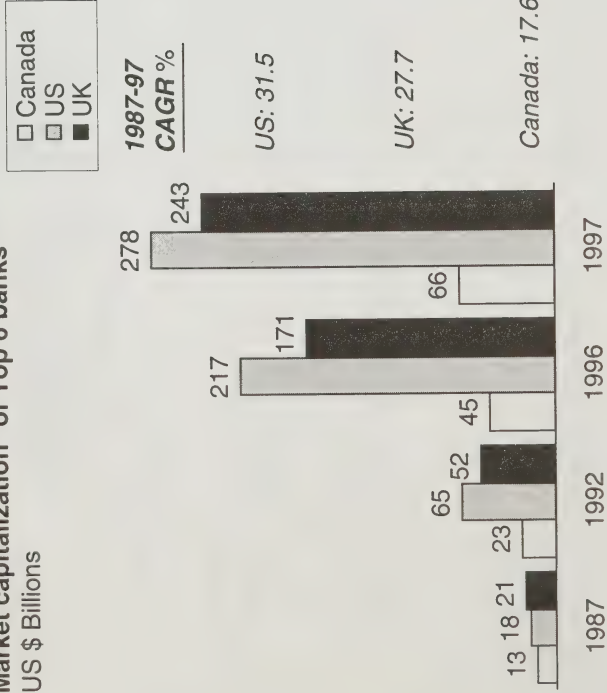
Source: DRI World Economic Outlook; TSE; The Financial Post database; McKinsey analysis

Domestic financial services sector assets, 1997
US \$ Billions, percent

* Excludes mutual funds held by banks
 ** Other includes monetary authorities, investment dealers, P&C insurers, other private financial institutions, public financial institutions, and issuers of asset-backed securities
 Source: National Balance Sheet Accounts; Flow of Funds Accounts of the United States, Reserve Bank of Australia, ONS Finstats

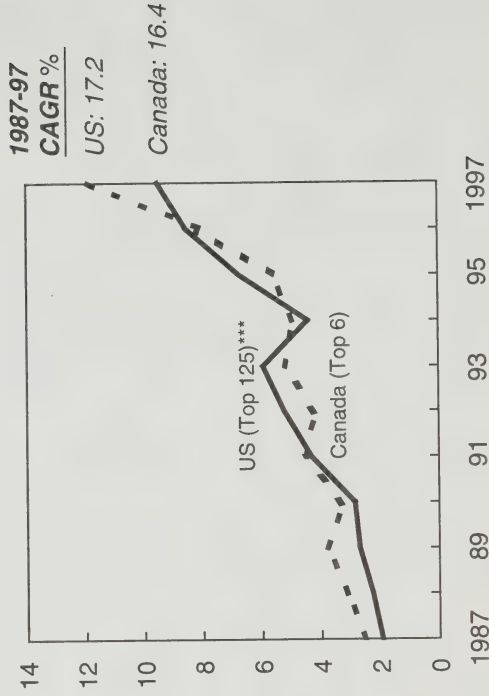
CANADA'S BANKS HAVE GROWN CONSIDERABLY SLOWER THAN THEIR INTERNATIONAL COUNTERPARTS

Market capitalization* of Top 6 banks**
US \$ Billions



Market capitalization as a percentage of GDP

Percent

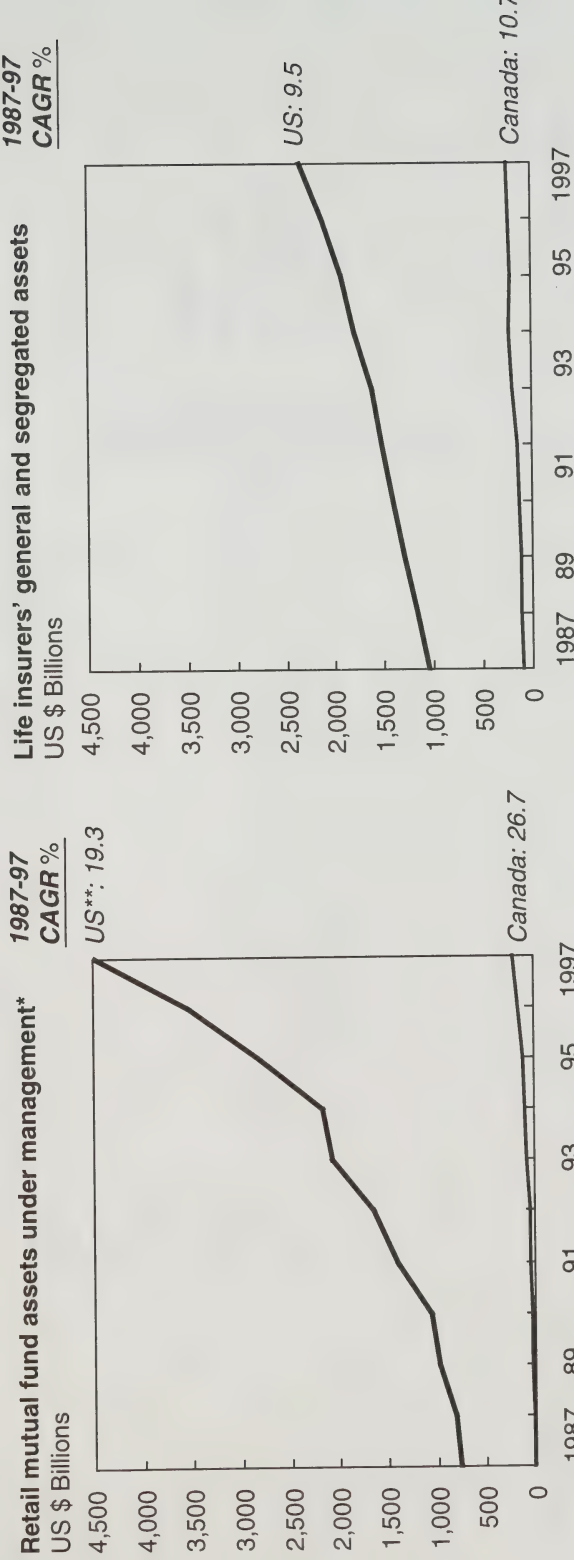


* As at December 31 of respective year

** Ranked by asset size in 1996

*** The Top 125 banks in the US were compared to the Top 6 in Canada because of a similar GDP relationship

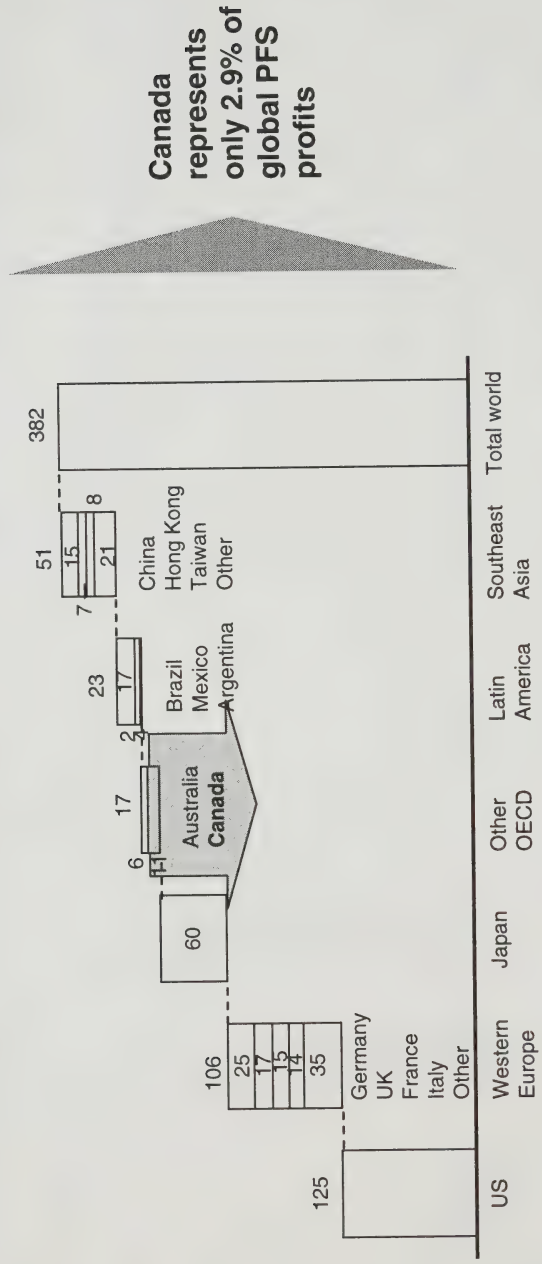
CONVERSELY, GROWTH IN RETAIL MUTUAL FUNDS AND LIFE INSURANCE ASSETS
IN CANADA HAS OUTPACED THAT IN THE UNITED STATES



CANADA HAS A SMALL SHARE (2.9%) OF GLOBAL PERSONAL FINANCIAL SERVICES (PFS) AND INSURANCE PROFITS

Global PFS and insurance profits
US \$ Billions, 1997

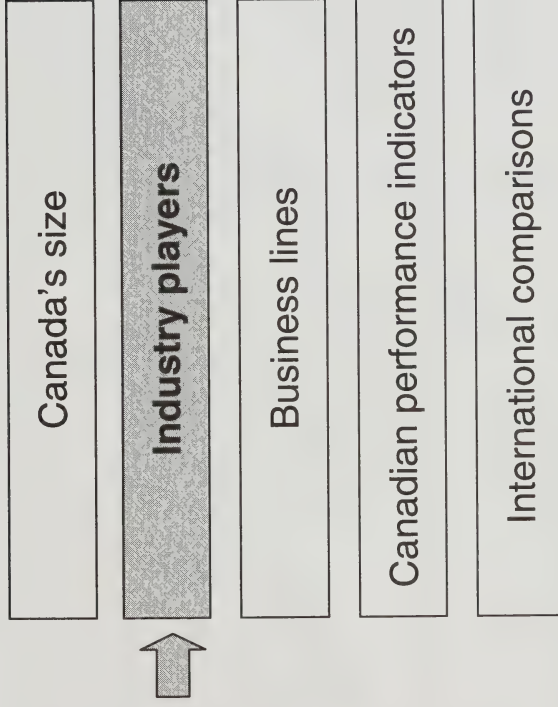
ESTIMATES



Canada represents only 2.9% of global PFS profits

Refer to Exhibit 2 - 21

	US \$	Cdn \$
PFS	9.6	13.0
Insurance	1.0	1.4
	10.6	14.4



A VARIETY OF INSTITUTIONS PROVIDE FINANCIAL SERVICES
TO CANADIAN CONSUMERS AND BUSINESSES

Financial institutions 1997	Number of players	Total assets Cdn \$ Billions
Banks	53	1,224 ¹
Life insurers	131	338 ²
Credit unions/caisses populaires	2,434	107 ³
Finance companies	130	37 ¹
Non-bank trust companies	37	56 ¹
Non-bank-owned retail mutual fund managers	64	213 ⁴
Bank-owned retail mutual funds	11	70 ⁴
Pension fund managers	>125	450 ²
Investment dealers	172	21 ²
Others	n/a	270 ⁵
Total	>3,157	\$2,786

- 1 October 1997
- 2 December 1997 estimate
- 3 Third quarter 1997
- 4 December 1997
- 5 December 1997 estimate

includes public financial institutions, other private financial institutions, property & casualty insurers, and issuers of asset-backed securities

Source: Bank of Canada; Benefits Canada; OSFI; IFIC; Statistics Canada; The Conference Board of Canada; Canadian Finance and Leasing Association; McKinsey & Company analysis

BANKS HOLD THE DOMINANT SHARE OF THE CANADIAN FINANCIAL SERVICES INDUSTRY'S ASSETS*

Cdn \$ Billions, percent

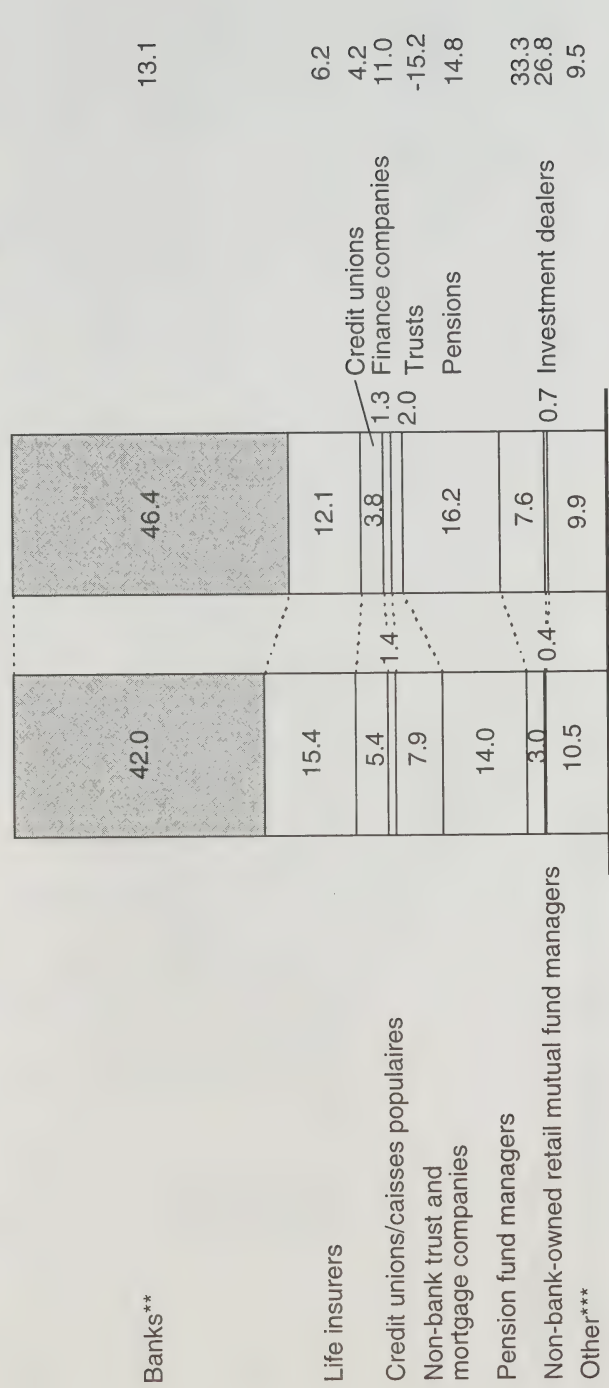
1992-97
CAGR
Percent

11.4

Of which
\$2,200 are
domestic

100% = 1,621

2,786



* Includes domestic and foreign assets

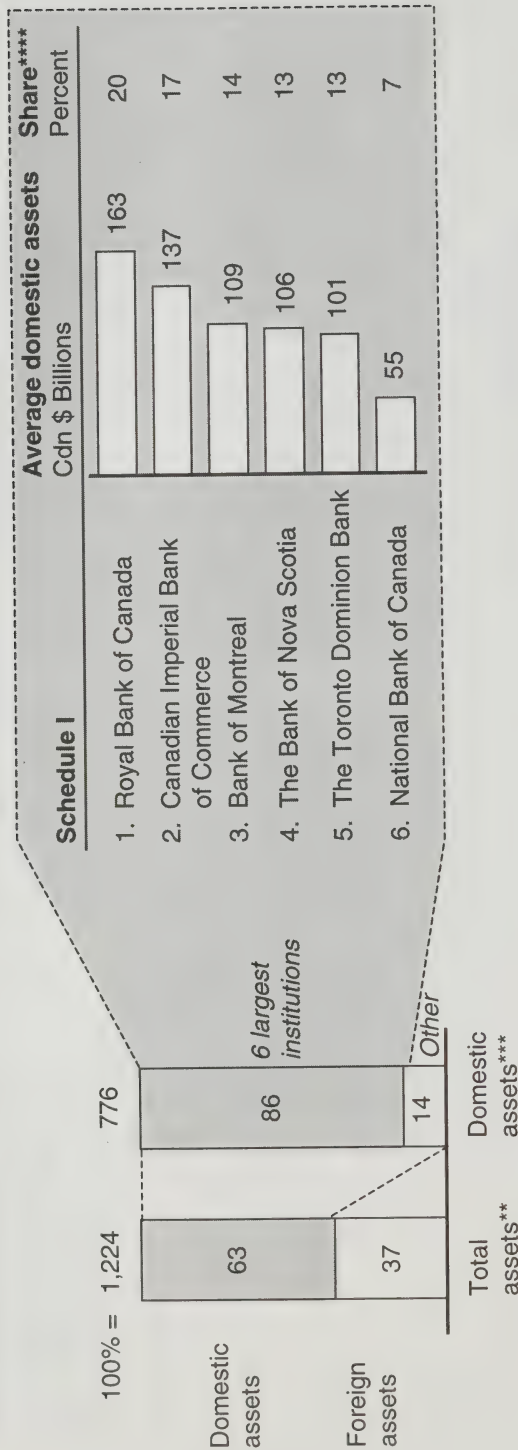
** Includes total assets on balance sheet and mutual fund assets under management

*** Public financial institutions, other private financial institutions, property & casualty insurers, and issuers of asset-backed securities

Banks

THE BANKING INDUSTRY IS HIGHLY CONCENTRATED

Bank assets* – 1997
Cdn \$ Billions, percent



1992-97 CAGR
6 largest institutions
domestic bank assets

+11.0%

1992-97 CAGR
6 largest institutions
total bank assets

+13.1%

* Includes balance sheet assets only (i.e., does not include retail assets under management)
** Includes total assets (foreign and domestic) of all banks operating in Canada
*** Includes only those assets held in Canada
**** Of total domestic assets

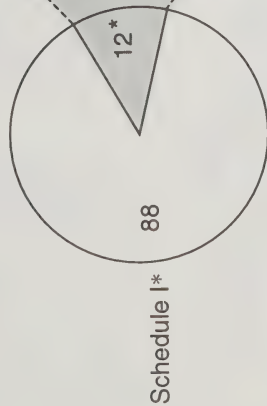
Source: Bank of Canada; Canadian Bankers Association: annual reports. OSFI

SCHEDULE II BANKS ARE FRAGMENTED AND REPRESENT ONLY 12% OF CANADIAN BANKING ASSETS

Domestic bank assets – 1997

Cdn \$ Billions, percent

100% = 776



1992-97 CAGR

Schedule II

+9.1%

Schedule II	Domestic assets Cdn \$ Billions	Share Percent
Hongkong Bank	23.9	3.1
Deutsche Bank	8.7	1.1
Citibank	7.2	0.9
Bank of America	5.0	0.6
Société Générale	4.5	0.6
ABN Amro Bank	3.9	0.5
BT Bank of Canada	3.8	0.5
Bank of Tokyo-Mitsubishi	3.1	0.4
Crédit Lyonnais	2.7	0.3
Bank Nationale de Paris	2.6	0.3
Union Bank of Switzerland	2.6	0.3
Crédit Suisse First Boston	2.6	0.3
Banca Commerciale Italiana	2.0	0.2
Other	20.8	2.7
Total	93.4	11.8

* Schedule I includes 6 largest banks plus Canadian Western Bank and Laurentian Bank

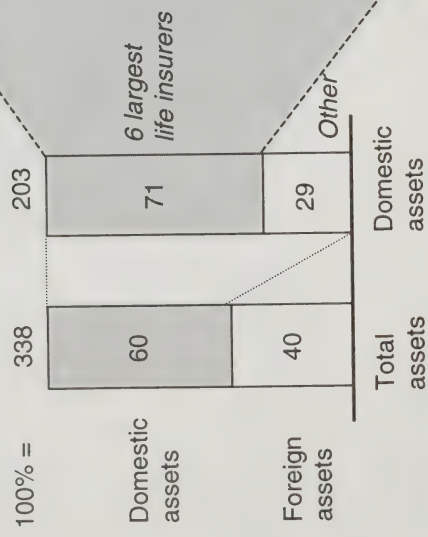
Source: Bank of Canada; OSFI; McKinsey & Company analysis

Life insurance companies

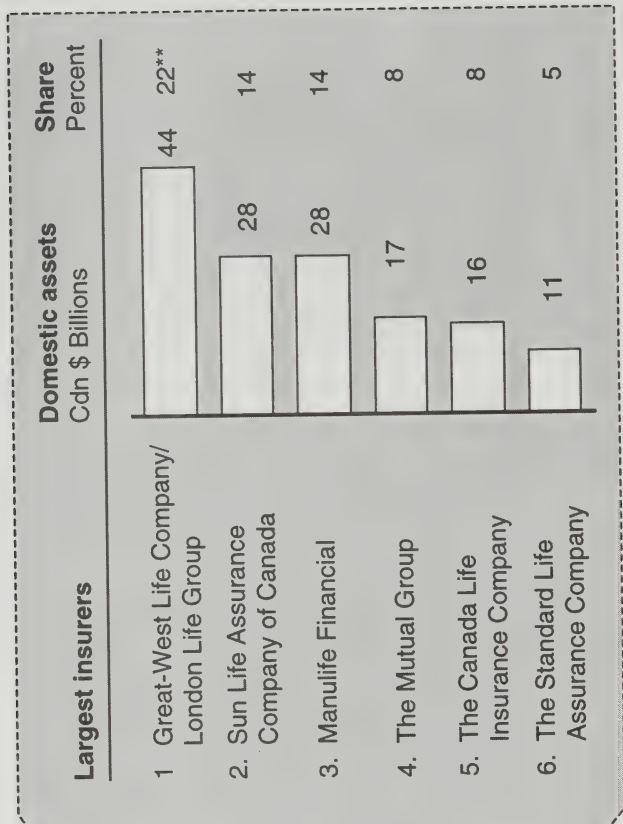
THE LIFE INSURANCE INDUSTRY IS ALSO CONCENTRATED

Canadian life insurance assets – 1997*

Cdn \$ Billions, percent



1992-97 CAGR
Industry
+6.2%



* General and segregated funds for 1997 based on estimates

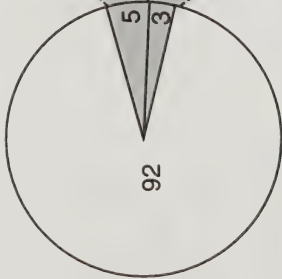
** Great-West Life Company and London Life Group pro forma

Credit unions and trust companies

CREDIT UNIONS AND NON-BANK TRUST COMPANIES HOLD A SMALL PERCENTAGE OF DOMESTIC FINANCIAL INSTITUTION ASSETS

Financial institution domestic assets – 1997
Cdn \$ Billions, percent

100% = 2,200



1992-97 CAGR

Credit unions/caisses populaires

+4.4%

1992-97 CAGR

Non-bank-owned trust companies

-15.5%***

Credit unions	Assets* Cdn \$ Billions
1. Mouvement des caisses Desjardins	57.4
2. Vancouver City Savings Credit Union	4.8
3. Surrey Metro Savings Credit Union	1.8
4. Richmond Savings Credit Union	1.7
5. Pacific Coast Savings Credit Union	1.2
Other	37.5

Credit unions/
caisses populaires

Non-bank
trusts

Non-bank trust companies	Assets** Cdn \$ Billions
1. CT Financial	44.5
2. Desjardins Trust	1.6
3. Mutual Trust Group	1.0
4. Investors Group Trust	1.0
5. Co-operative Trust	0.9
Other	6.6

* December 1996

** October 1997

*** Decline reflects bank purchases of Royal Trust and Montreal Trust during the period

Source: OSFI, Bank of Canada, The Financial Post 500; annual reports

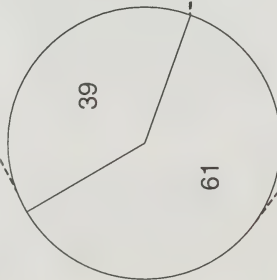
Asset managers

THE ASSET MANAGEMENT SECTOR HAS GROWN RAPIDLY

Assets under management – 1997

Cdn \$ Billions, percent

100% = 733



1992-97 CAGR

Retail

+33.3%

Institutional

+20.1%

Retail mutual fund managers	Assets Cdn \$ Billions	Share	
		Percent	Share
1. Investors Group	31.8	11	
2. Trimark Investment Management	27.3	10	
3. Royal Mutual Funds Inc.*	24.9	9	
4. Mackenzie Financial Corp.	21.3	8	
5. Templeton Management Ltd.	16.3	6	
6. TD Asset Management*	13.3	5	
Other (approx. 60 players)	111.0	51	

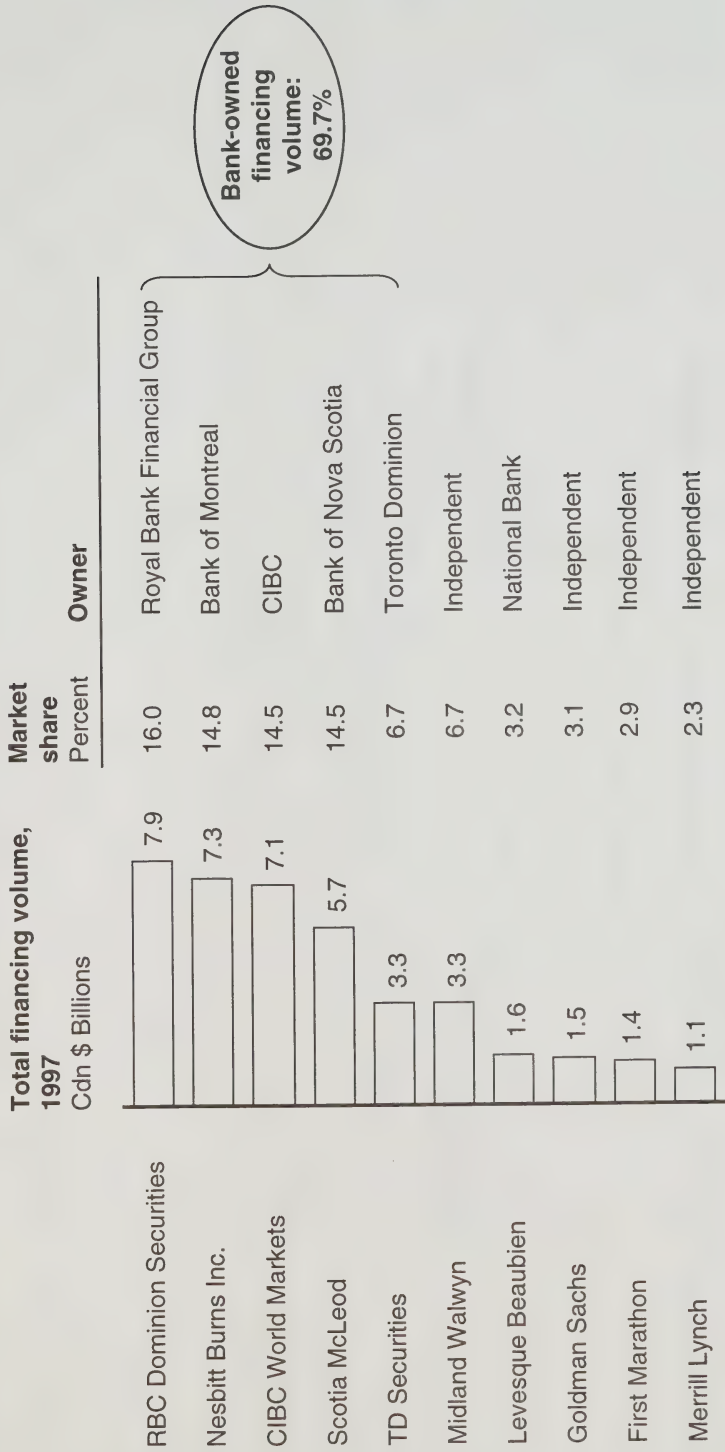
Institutional pension fund managers	Assets Cdn \$ Billions	Share	
		Percent	Share
1. Caisse de dépôt et placement du Québec	35.0	8	
2. Phillips, Hager and North	16.9	4	
3. TAL Investment Counsel	16.2	4	
4. RT Capital Management	14.8	3	
5. Sceptre Investment	12.3	3	
Other (approx. 125 players)	354.8	78	

* Bank-owned

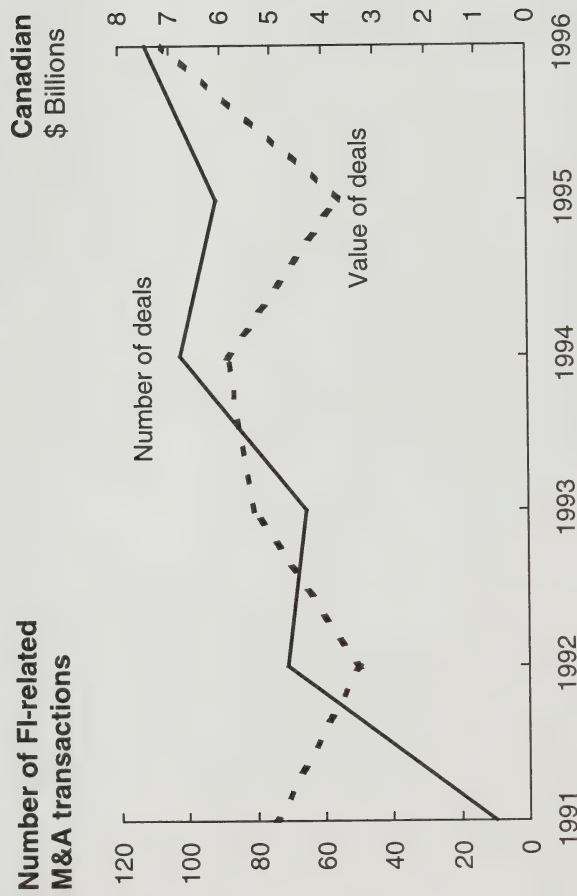
Source: IFIC; Benefits Canada; annual reports; McKinsey & Company analysis

Investment dealers

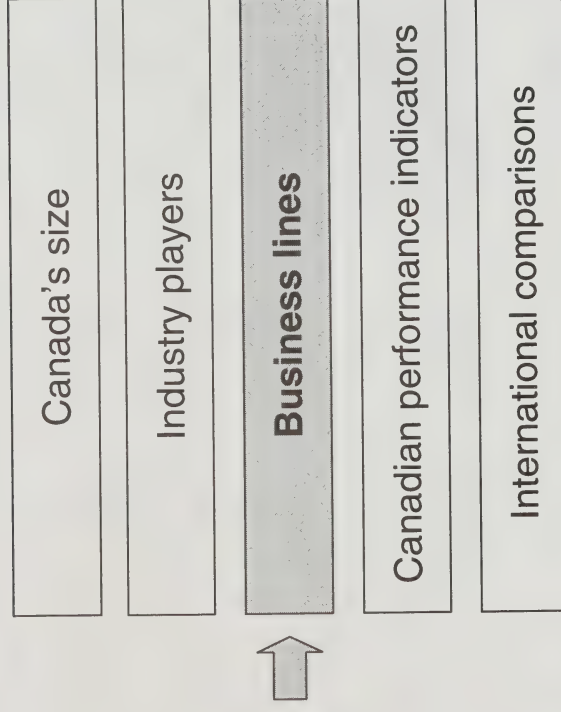
CANADIAN BANKS DOMINATE THE INVESTMENT BANKING INDUSTRY THROUGH THEIR INVESTMENT BROKERAGE SUBSIDIARIES



THERE HAS BEEN SIGNIFICANT MERGER & ACQUISITION* ACTIVITY IN CANADA

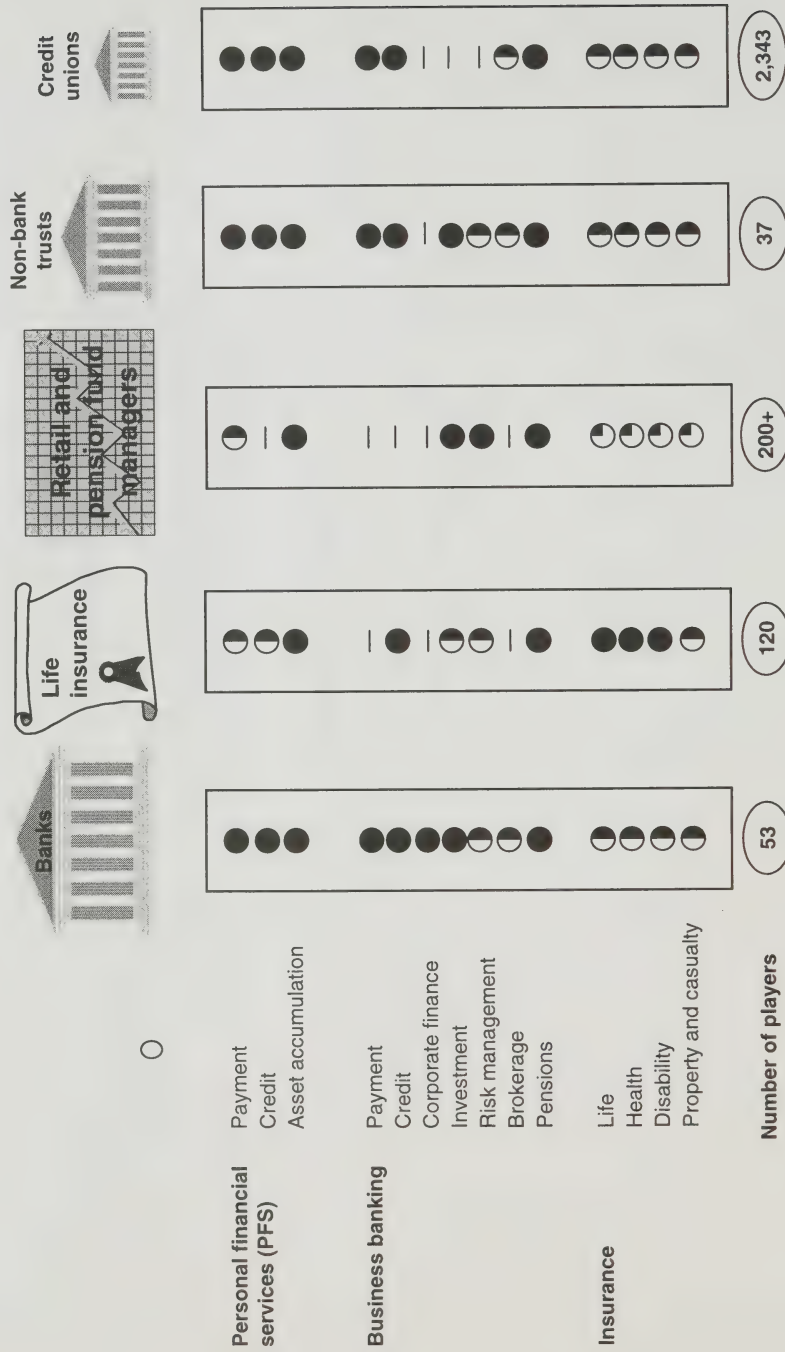


* See Appendix for detailed list of mergers and acquisitions
Source: *Directory of Mergers and Acquisitions in Canada*, M&A Publishing

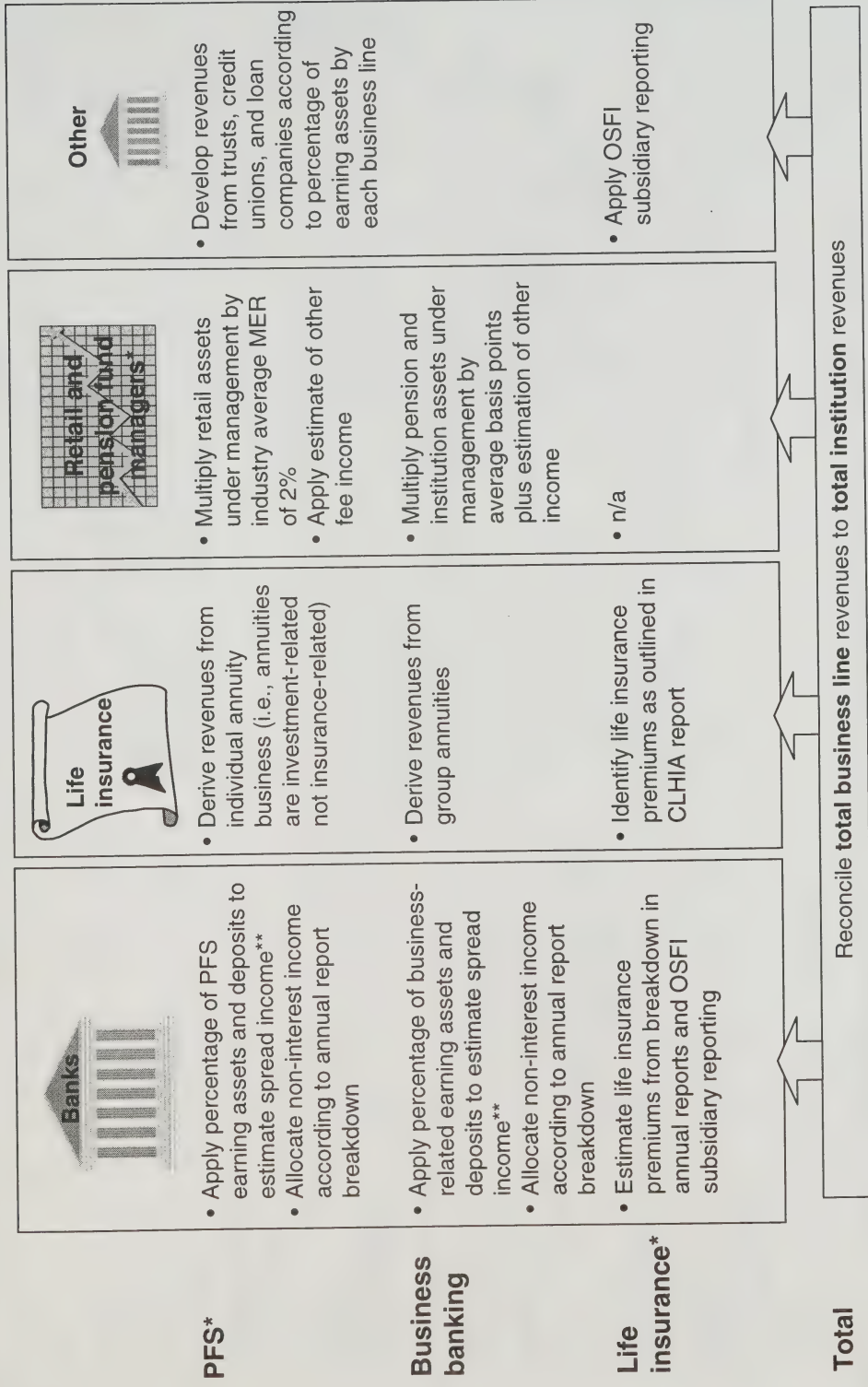


CANADIAN FINANCIAL INSTITUTIONS COMPETE ACROSS THE FINANCIAL SERVICES LANDSCAPE

○ Provided through affiliation ● Provided through subsidiary ● Provided through own operations



DISAGGREGATING FINANCIAL INSTITUTIONS' REVENUES BY BUSINESS LINES REQUIRES ESTIMATION



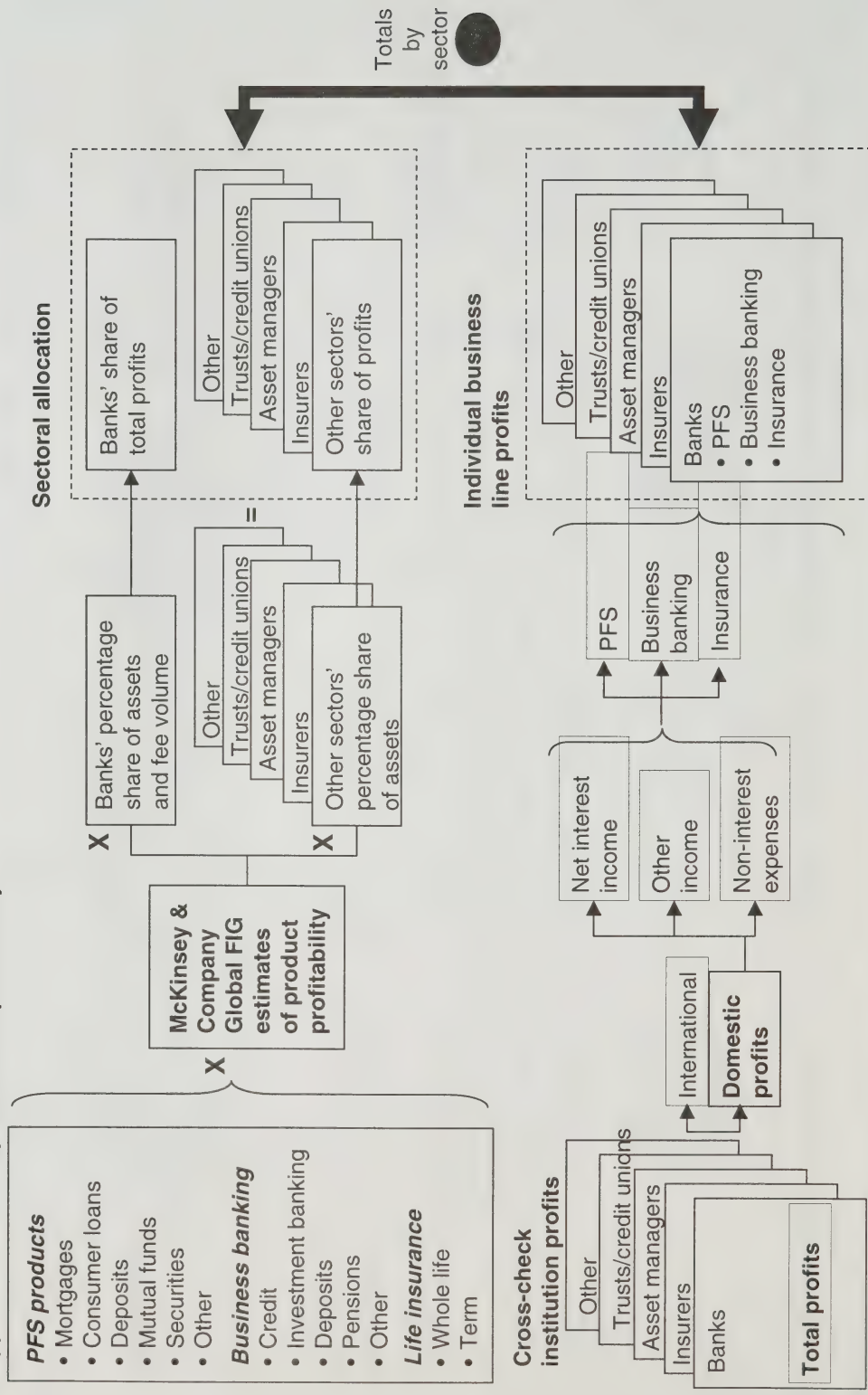
* Annual report divisions were used where possible

** Excludes loan loss provision

Source: McKinsey & Company analysis

DOMESTIC PRODUCT LINE PRETAX PROFITABILITY WAS ESTIMATED AND CROSS-CHECKED


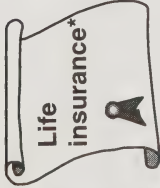
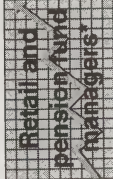

Approach: Estimate product line profitability



TOTAL SECTOR AND BUSINESS LINE PRETAX REVENUES AND PROFITS EARNED IN CANADA 1997

Cdn \$ Billions

ESTIMATES

									Other**		Total	
	\$	%	\$	%	\$	%	\$	%	\$	%	\$	%
PFS												
Revenue	21.3	44	7.1	14	5.6	11	6.7	13	8.9	18	49.6	47
Profits (pre-tax)	6.4	49	0.9	7	1.4	11	1.6	12	2.7	21	13.0	69
Business banking												
Revenue	12.1	31	6.2	16	14.0	36	1.7	4	5.0	13	39.0	37
Profits (pre-tax)	2.0	44	0.4	9	1.0	22	0.1	2	1.0	22	4.5	24
Life & health insurance premium income												
Revenue	2.4	15	13.2	80	n/a	n/a	0.95		n/a		16.5	16
Profits (pre-tax)	0.2	14	1.1	79	n/a	n/a	0.17		n/a		1.4	7
Total												
Revenue	35.8	34	26.5	25	19.6	19	9.3	9	13.9	13	105.1	100
Profits (pretax)	8.6	45	2.4	13	2.4	13	1.8	9	3.7	20	18.9	100

* 1997 estimates based on 1996 results

** Other includes independent investment dealers, finance companies

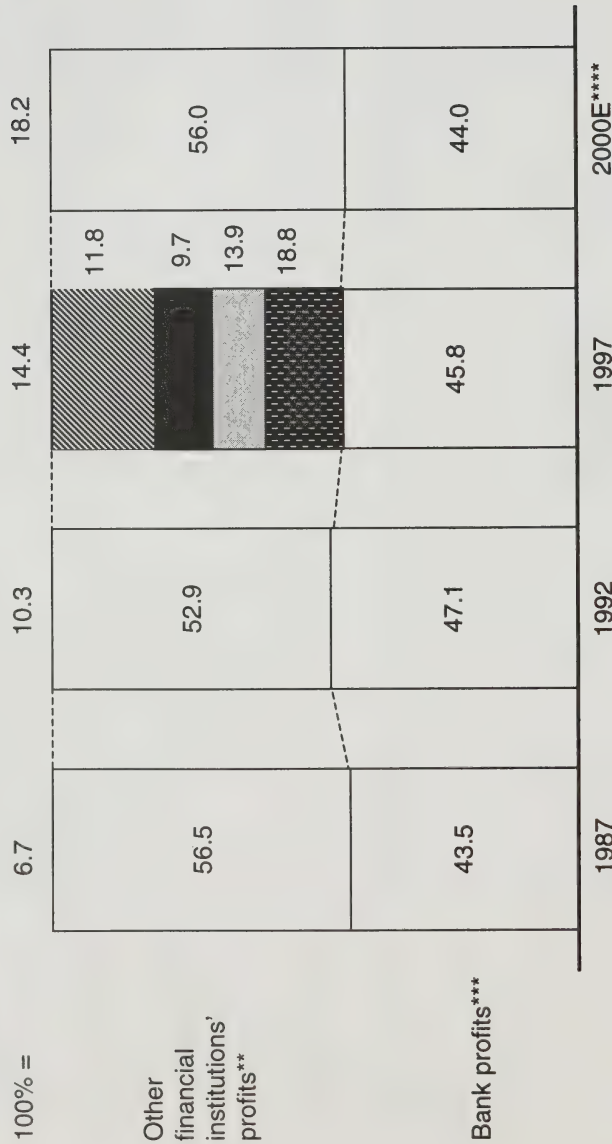
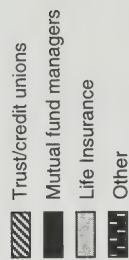
Source: OSFI; annual reports; Canadian Life and Health Insurance Association; Benefits Canada; Bank of Canada; IFIC; Statistics Canada; McKinsey & Company analysis

BANKS CONTROL LESS THAN HALF OF CANADIAN PFS AND LIFE INSURANCE PROFITS

ESTIMATES

Total pretax PFS* and insurance profits

Cdn \$ Billions, percent



* Includes before-tax profits in mortgages, consumer loans, deposits, mutual funds, securities, and life insurance

** Other includes trusts, finance companies, life insurance companies; credit unions, mutual fund managers, pension managers

*** Chartered banks

**** Assumes no major insurance acquisitions by the banks

Source: Bank of Canada; IFIC; McKinsey & Company PFS Model; OSFI

PRODUCT PROFITABILITY VARIES WIDELY; PFS IS LARGELY ATTRACTIVE**1997 estimates**

Segment		Profits* Cdn \$ Billions	ROE Percent	Top 6 bank concentration Percent
PFS	1. Residential mortgages	2.8	20-30	53
	2. Consumer loans	1.0	10-15	62
	3. Credit cards	1.0	30-40	63
	4. Deposits**	6.5		59
	5. Asset management • Retail (mutual funds, annuities)	<u>1.7</u> 13.0	15-25	23
Business banking	6. Commercial • Small/medium • Large	1.3 0.4	10-15 0-10	76***
	7. Investment banking/brokerage	1.0	10-20	70
	8. Pensions and group annuities	<u>1.8</u> 4.5	8-10	15
Segment		Profits*	ROE	Top 6 insurer concentration
Insurance { 9. Insurance (life and health)		<u>1.4</u>	8-12	58****
Total		18.9		

* Estimated pretax profit in Cdn dollars; does not take into consideration issues of shared costs in branch system

** Includes earnings from bank securities and interbank deposits

*** Concentration for business loans as defined by Bank of Canada

**** Based on 1996 group and individual life premiums with proforma Great West/London Life

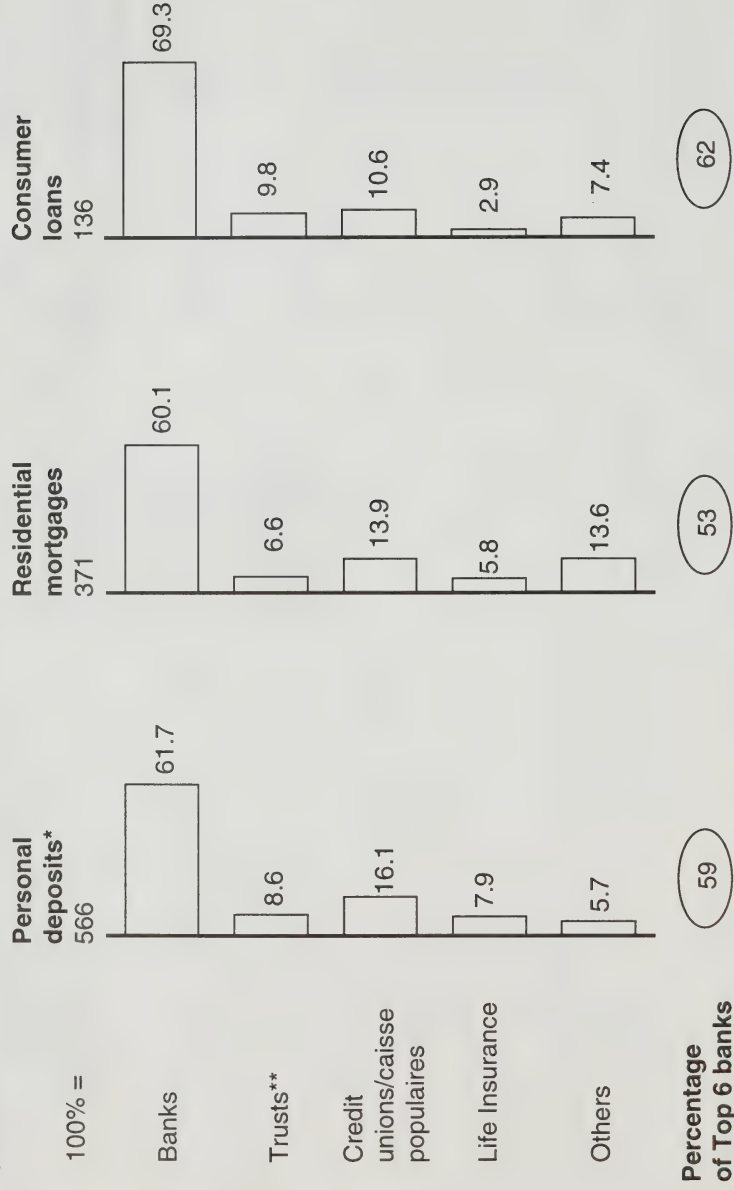
Source: Annual reports; interviews; Bank of Canada, 1996; McKinsey & Company analysis

BANKS HOLD THE DOMINANT SHARE IN DEPOSITS, RESIDENTIAL MORTGAGES, AND PERSONAL LOANS

ESTIMATES

Product concentration 1997

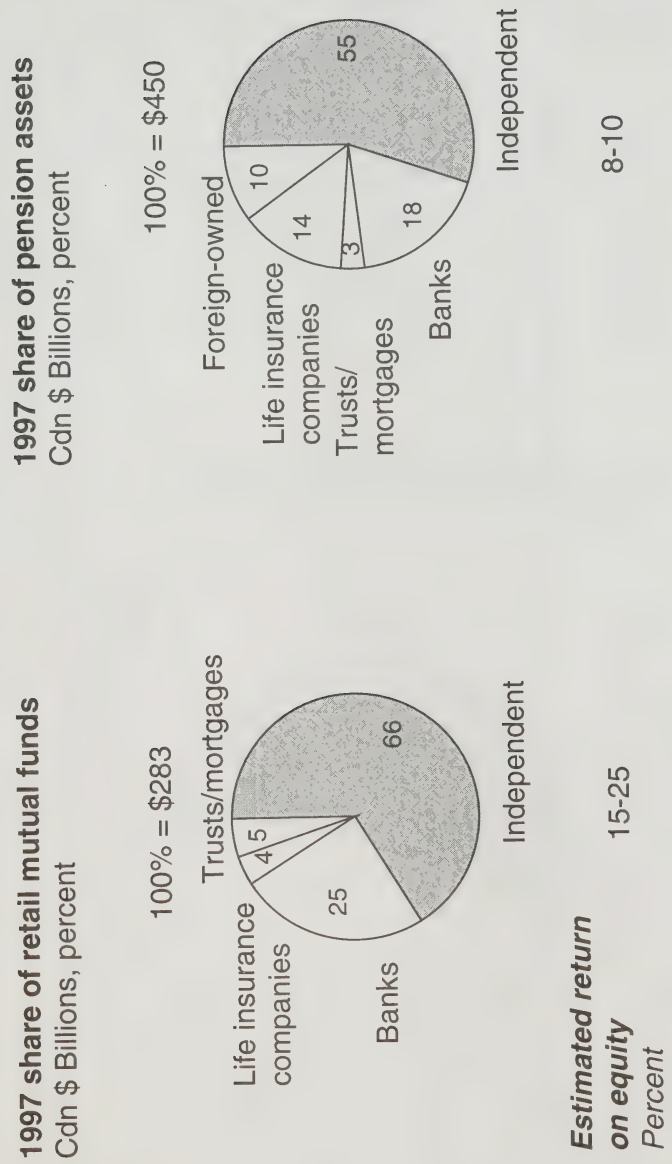
Cdn \$ Billions, percent



* Excludes foreign currency deposits; includes personal notice and demand deposits plus life insurers' individual annuities and money market mutual funds

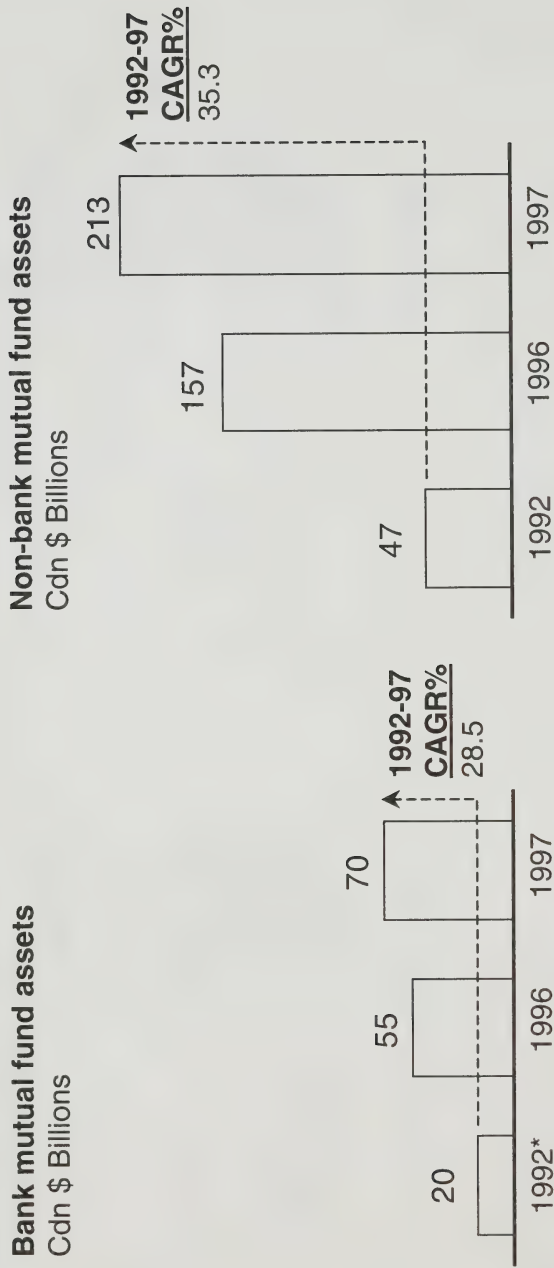
** Independent, includes Canada Trust

INDEPENDENT FIRMS DOMINATE THE ASSET MANAGEMENT INDUSTRY



Source: IFIC; Benefits Canada; *Investor Economics*; McKinsey & Company analysis

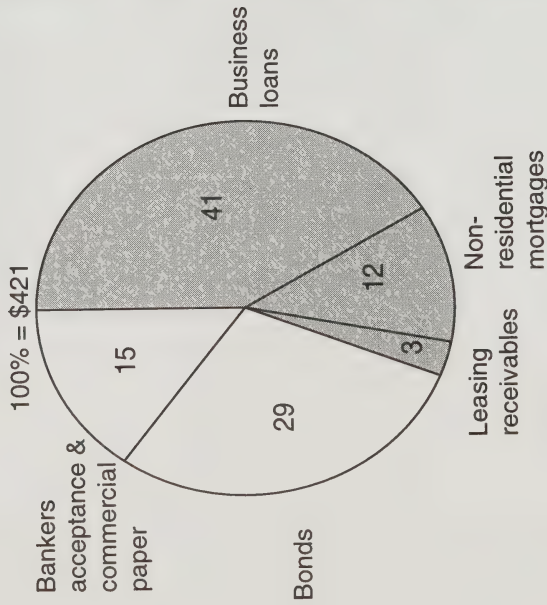
BOTH BANK AND NON-BANK MUTUAL FUND ASSETS ARE GROWING QUICKLY



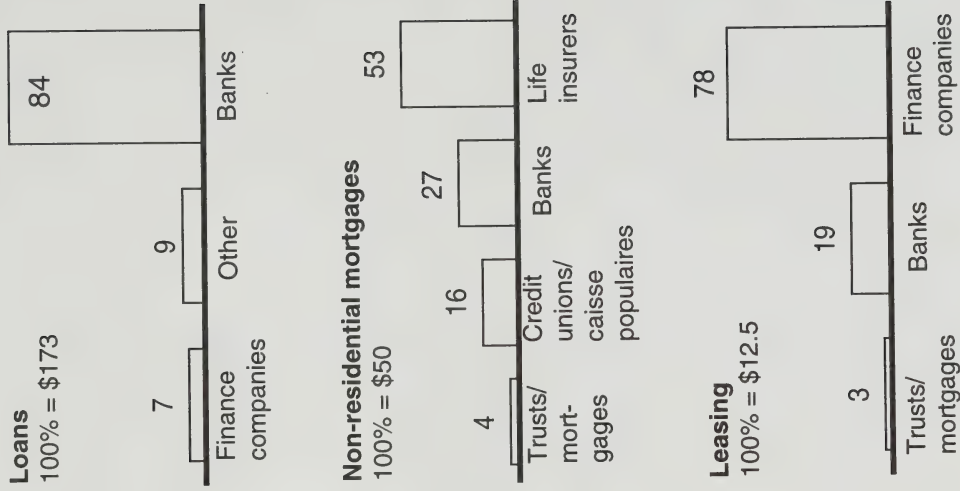
* Includes Royal Trust

BUSINESS CREDIT IS PROVIDED THROUGH MULTIPLE CREDIT INSTRUMENTS BANKS DOMINATE BUSINESS LOANS

1997 composition of business credit*
Cdn \$ Billions, percent



Banks hold 38% of total business credit



* As defined on Table E2 Bank of Canada Review
Source: Bank of Canada, McKinsey & Company analysis

Canada's size

Industry players

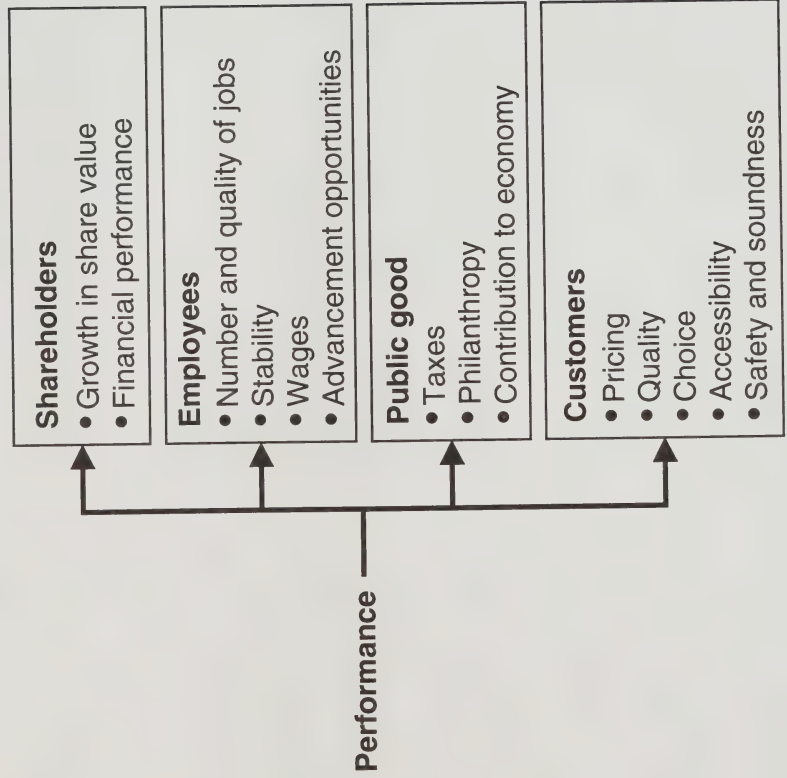
Business lines

Canadian performance indicators

International comparisons

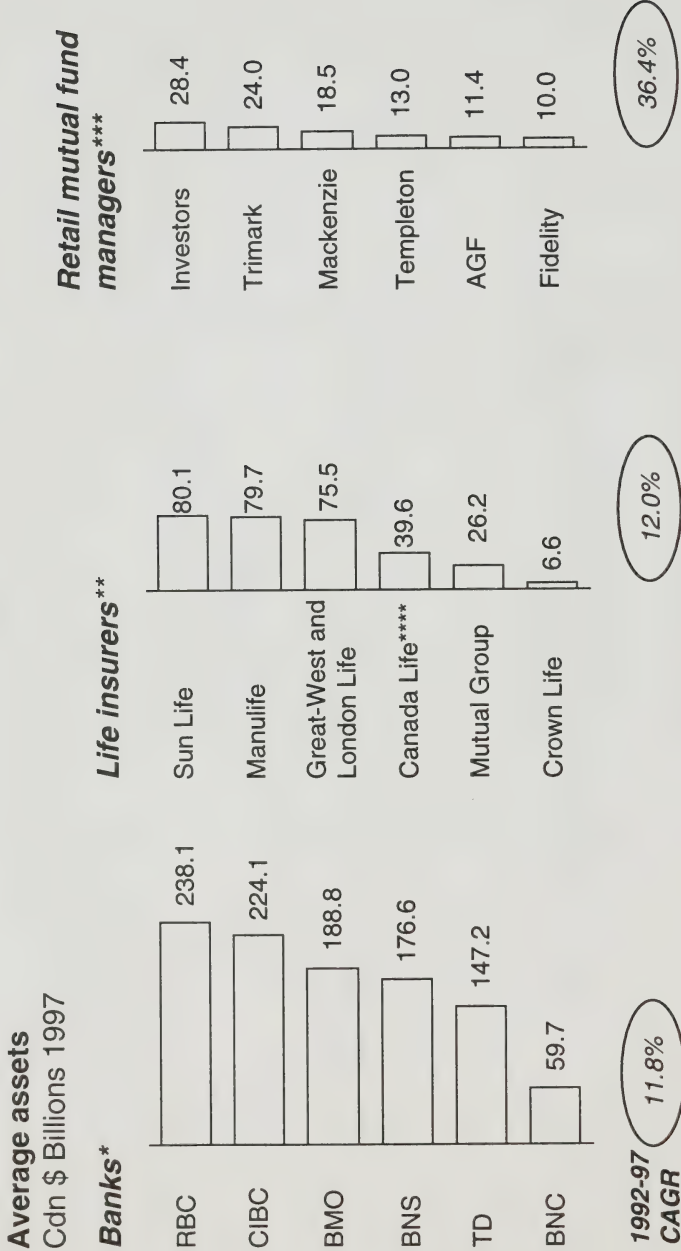


FINANCIAL INSTITUTION STAKEHOLDERS HAVE DIFFERENT PERFORMANCE CRITERIA



Shareholders

CANADA'S TOP BANKS ARE MUCH LARGER THAN THEIR COUNTERPARTS IN LIFE INSURANCE AND RETAIL MUTUAL FUNDS



* October 1997

** General and segregated assets – year-end 1997

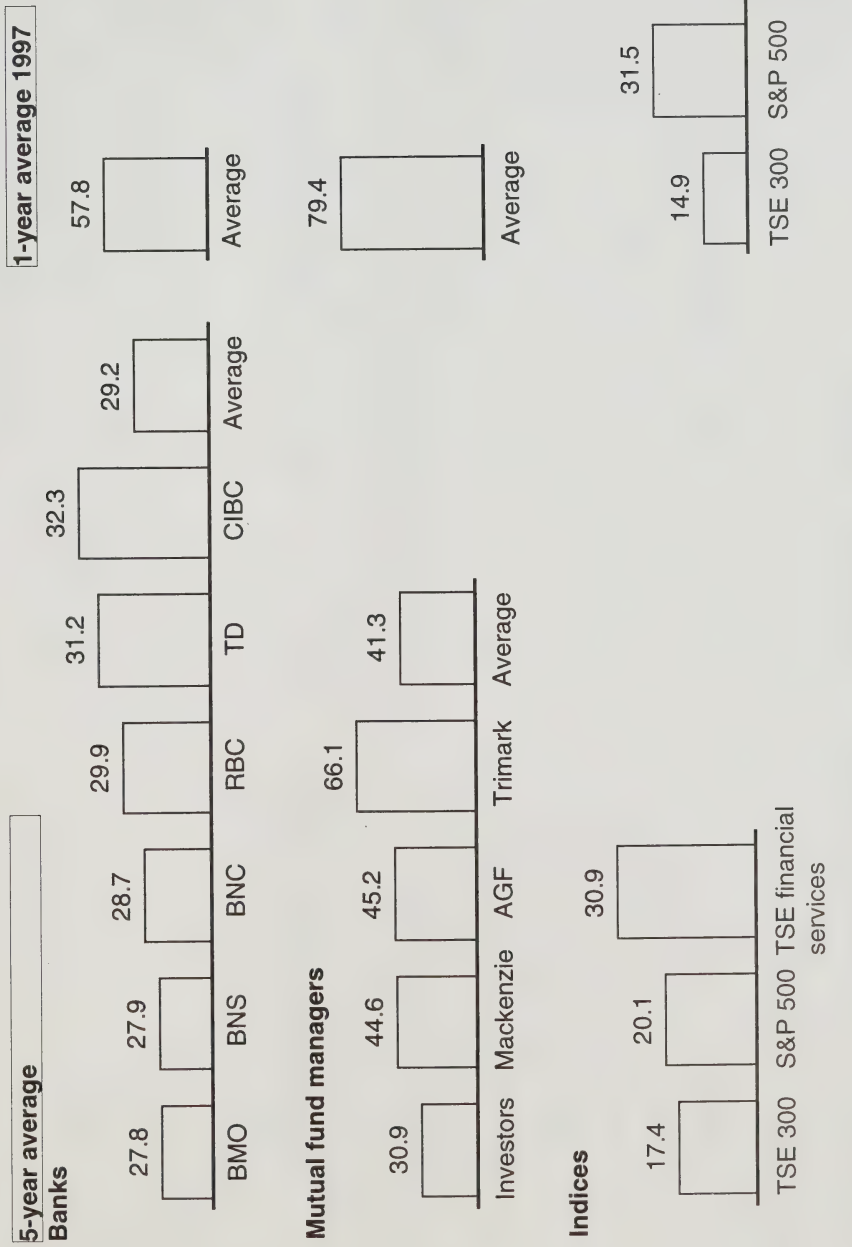
*** December 1997 assets under management

**** Includes purchase of MetLife UK

Source: Annual reports; IFC

RECENTLY, FINANCIAL SERVICES STOCKS HAVE PROVED VERY ATTRACTIVE

Total stock returns 1992-97
Percent



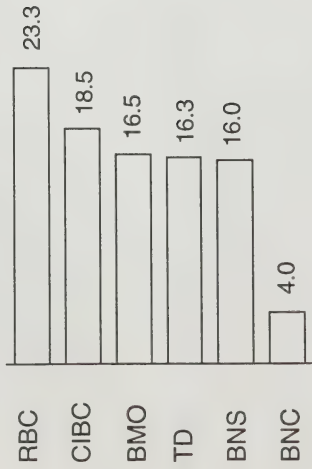
Source: TSE; McKinsey & Company analysis

VALUE GROWTH IN FUND MANAGERS HAS OUTPACED BANKS

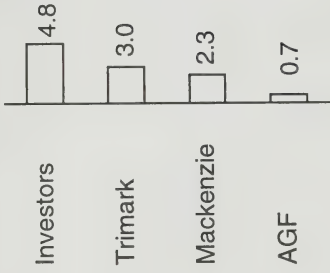
Market capitalization 1997

Cdn \$ Billions

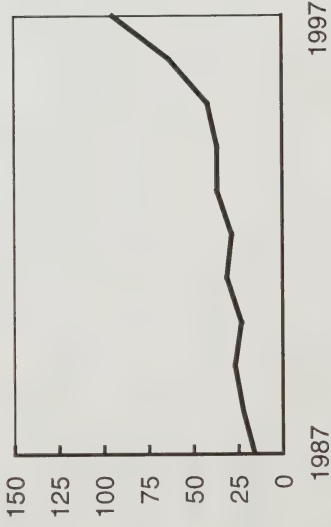
Banks



Retail mutual fund managers



Market capitalization growth



1987-97
CAGR
19.3%

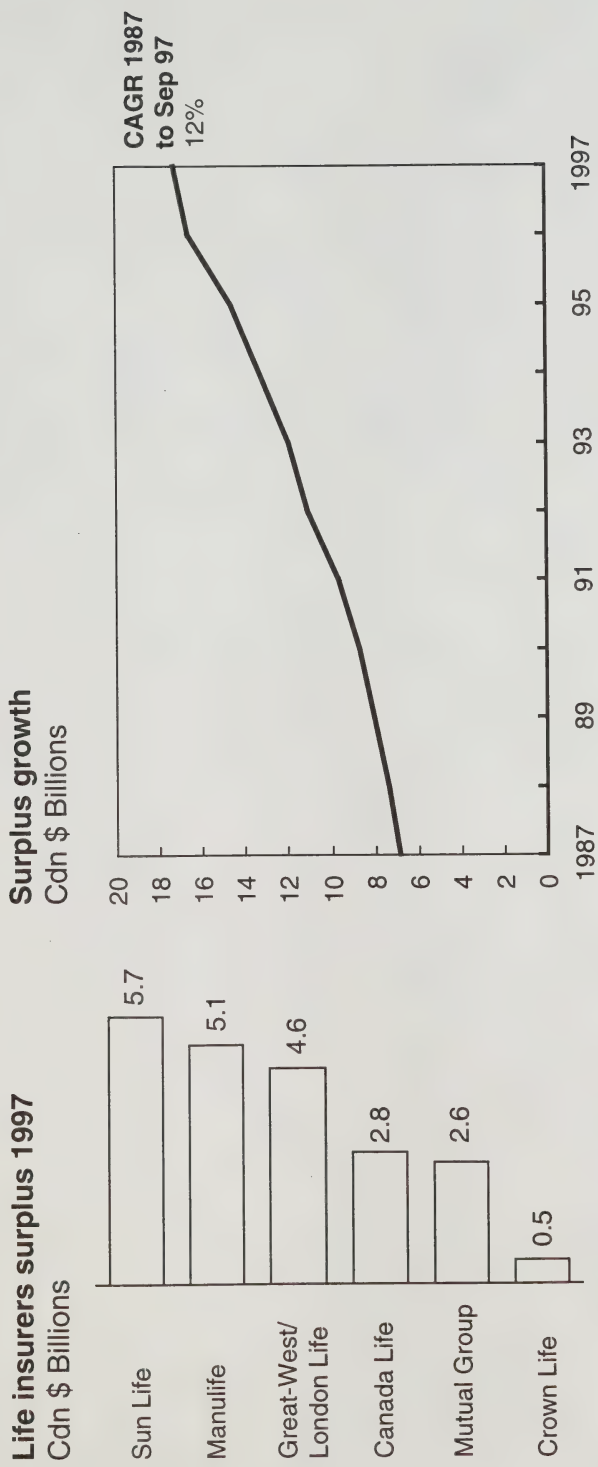
Market capitalization growth*



1987-97
CAGR
34.0%

* Trimark only included since 1992

LIFE INSURERS' RETURN ON SURPLUS HAS BEEN STEADY



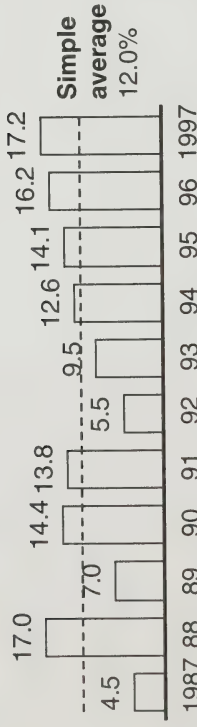
Source: Annual reports

RETURNS VARY WIDELY AMONG SECTORS

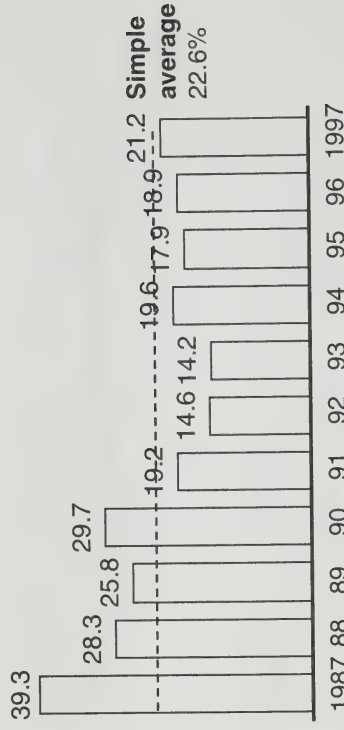
Average return on equity 1987-97*

Percent

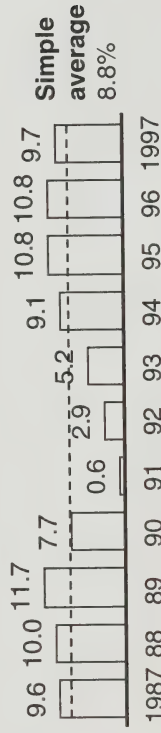
Top 6 banks



Top 4 retail mutual funds managers**



Top 6 life insurance companies***



* Straight average

** Templeton and Fidelity not included; 1997 ROE for AGF and Trimark estimated interim reports

*** Return on surplus

Source: Annual reports; The Financial Post database; Moody's Industry Outlook

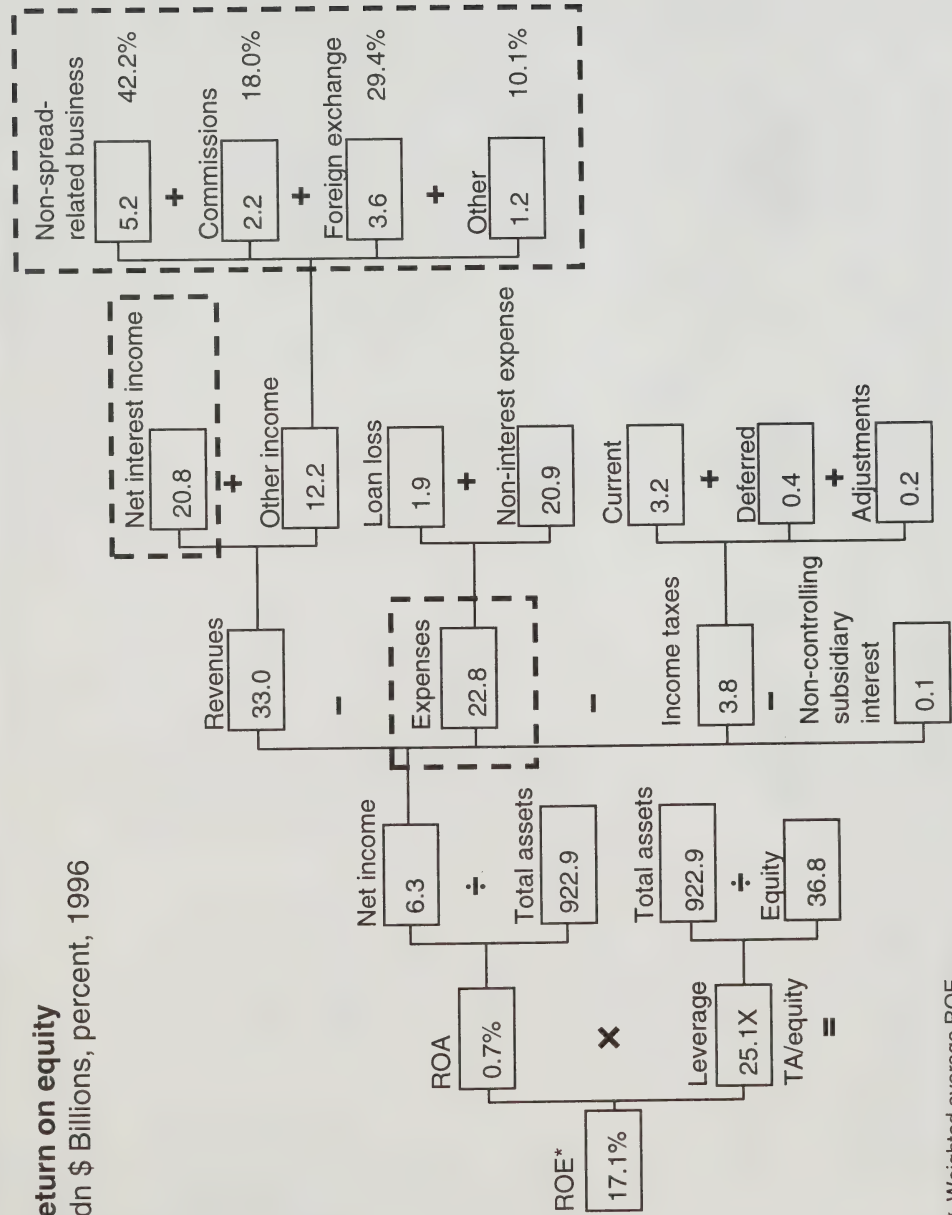
NET INTEREST INCOME, FEES, AND EXPENSES ARE KEY BANK VALUE DRIVERS

ESTIMATES

Key value drivers

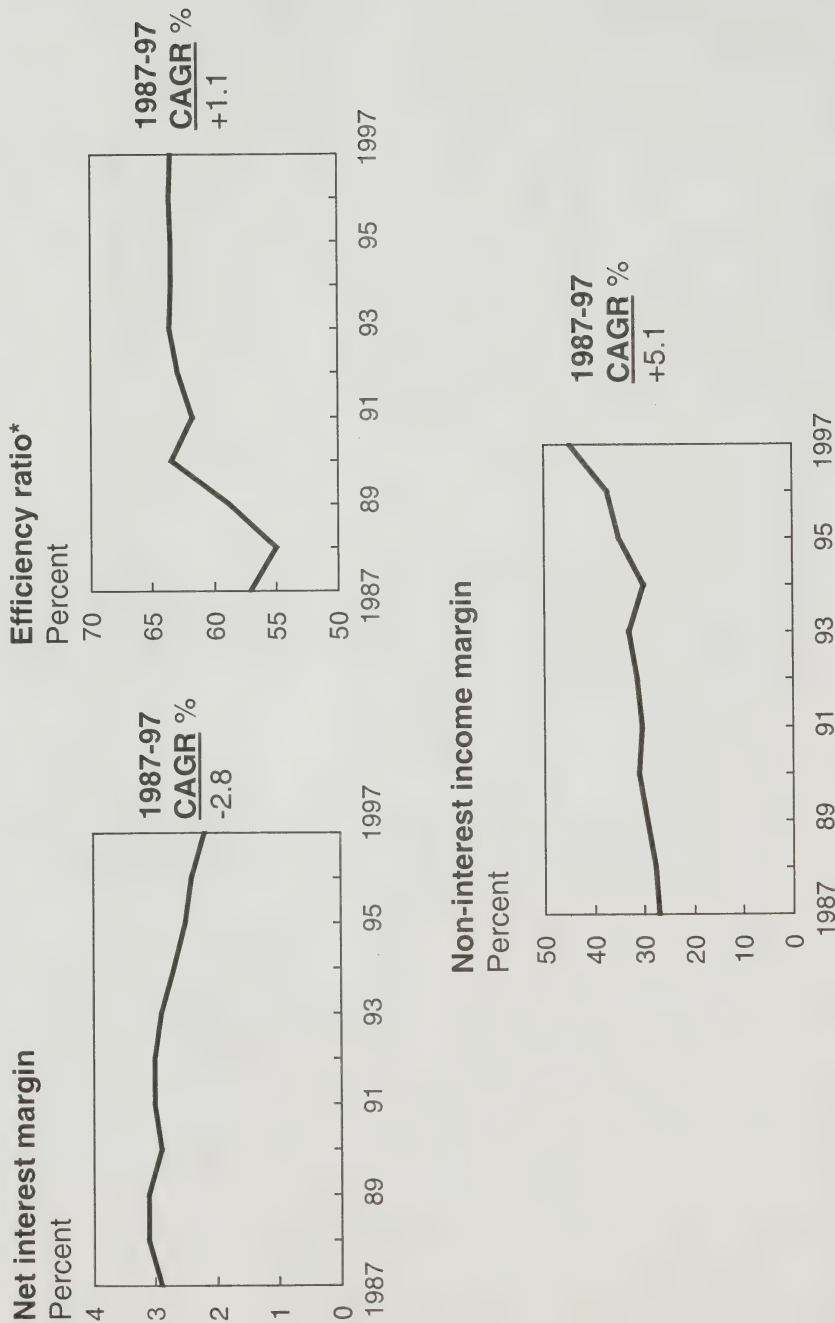
Return on equity

Cdn \$ Billions, percent, 1996



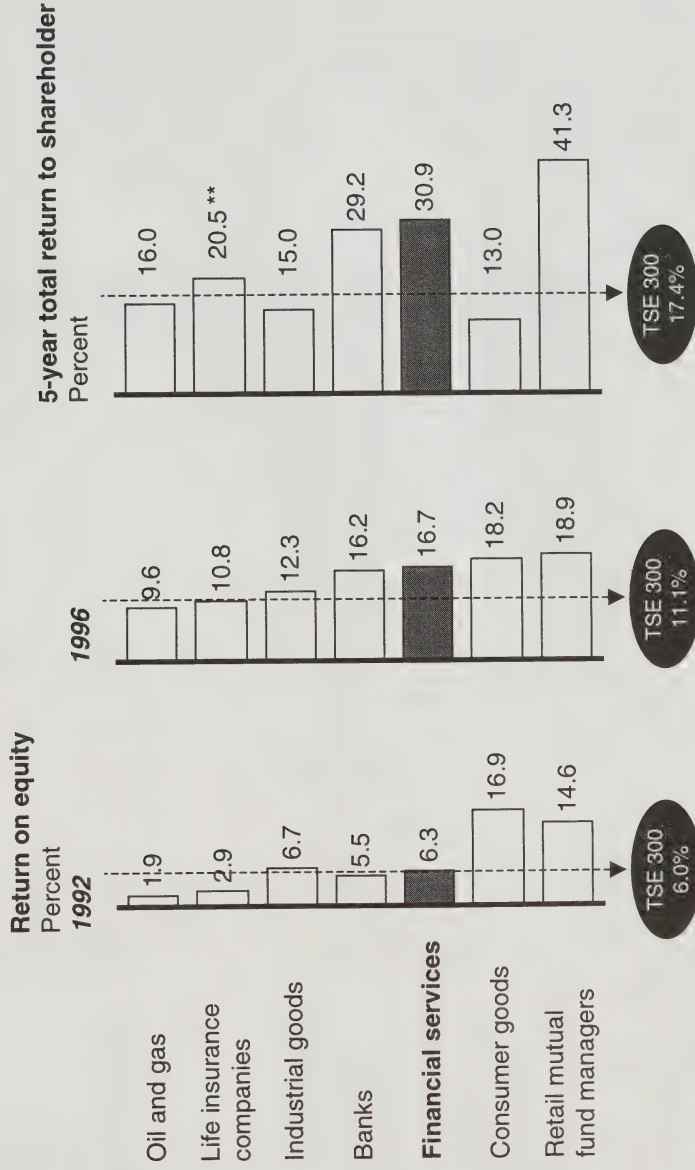
* Weighted average ROE
Source: OSFI; Bank of Canada

IMPROVED FEES HAVE OFFSET MARGIN DECLINES AND FLAT EFFICIENCY RATIOS



* Measure of a bank's productivity calculated as non-interest expense divided by operating revenues. The lower the percent, the more efficient the institution

THE FINANCIAL SERVICES SECTOR HAS OUTPERFORMED MOST SECTORS*



* Sectors according to TSE 300 classification: oil and gas – 15 companies; consumer goods – 8 companies; industrial – 22 companies; financial services – 15 companies

** Includes returns for Crown Life, Great-West, London Life (Great-West and London Life returns to December 1996)

Source: Annual reports; The Financial Post database

STOCK MARKET REWARDS GROWTH EXPECTATIONS

Canadian financial services market capitalization –

February 6, 1998

Percent

☐ Percentage of price attributable to present value* of after-tax earnings
☐ Percentage of price attributable to growth expectations

	<i>Present earnings</i>	<i>Future growth expectations</i>
Newcourt Credit	24	76
Mackenzie Financial	35	65
Investors Group	36	64
Trimark Financial	49	51
CT Financial	56	44
TD	80	20
RBC	83	17
BNS	88	12
BNC	88	12
BMO	88	12
CIBC	99	1

* Present value: the current value of future cash flows, discounted at an appropriate discount rate

Source: McKinsey & Company Growth Practice; The Financial Post database

Employees**FINANCE AND INSURANCE SECTOR EMPLOYMENT HAS BEEN ESSENTIALLY FLAT FROM 1987-97**

Employment Thousands of employees, percent	100% = 499		493	507	1987-97 CAGR %
Banks*	35	38	38	38	+0.2
Trust companies	6	7	7	4	+1.3
Credit unions	11	10	12	12	-3.4
Consumer & business finance companies	4	4	3	3	+1.0
Insurance companies**	18	21	20	20	-2.1
Other	26	20	23	23	+0.9
	1987	1992	1997		+1.2

* Banks' figures in 1992 and 1997 include employees in acquired brokerage and trust businesses

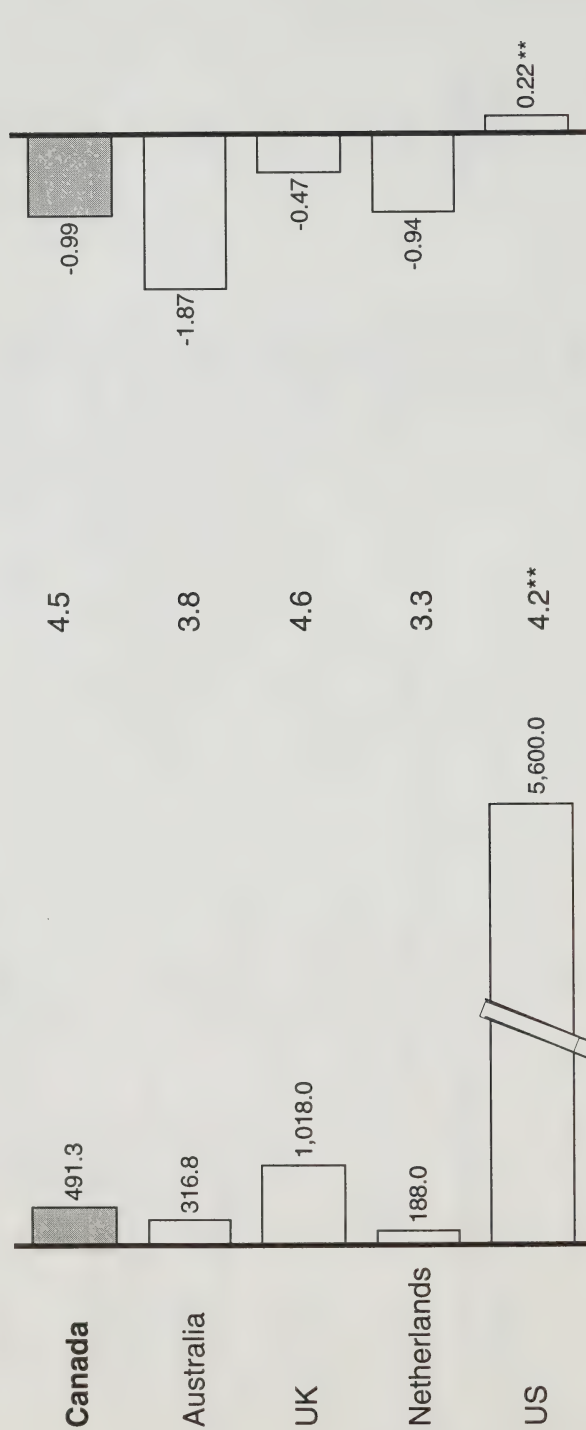
** Excluding agencies

Source: Statistics Canada

CANADA'S FINANCE SECTOR, IN LINE WITH OTHER COUNTRIES, EXPERIENCED A DECLINE IN EMPLOYMENT LEVELS

Average employment levels in Finance* sector

Thousands of employees, 1996



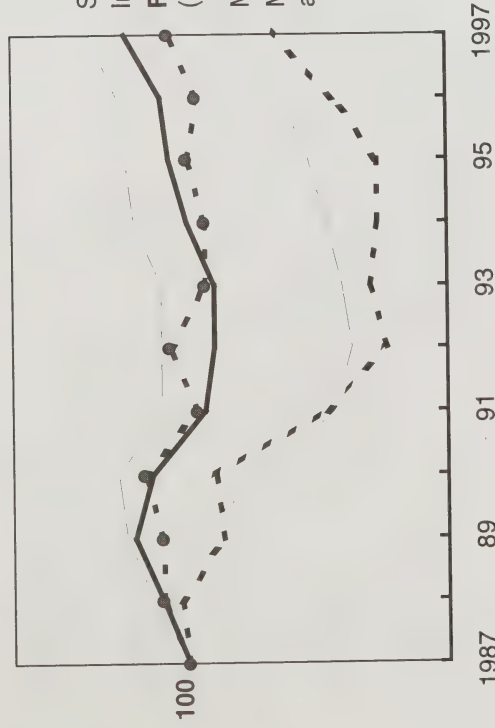
* Financing, Insurance sector

** Level as of 1994, CAGR 1990-94

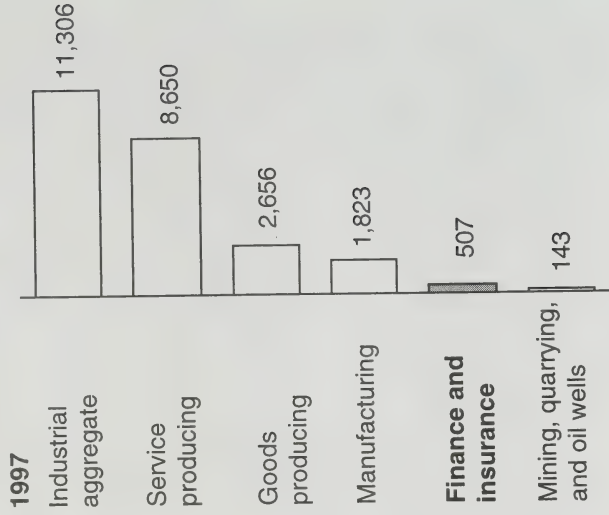
Source: Statistics Canada; Australian Economic Indicators; Labour Force Survey; CBS; Statistical Abstract of the United States, 1997

EMPLOYMENT LEVELS IN THE FINANCE AND INSURANCE SECTOR HAVE BEEN FLAT

Employment growth by sector, 1987-97*
Index



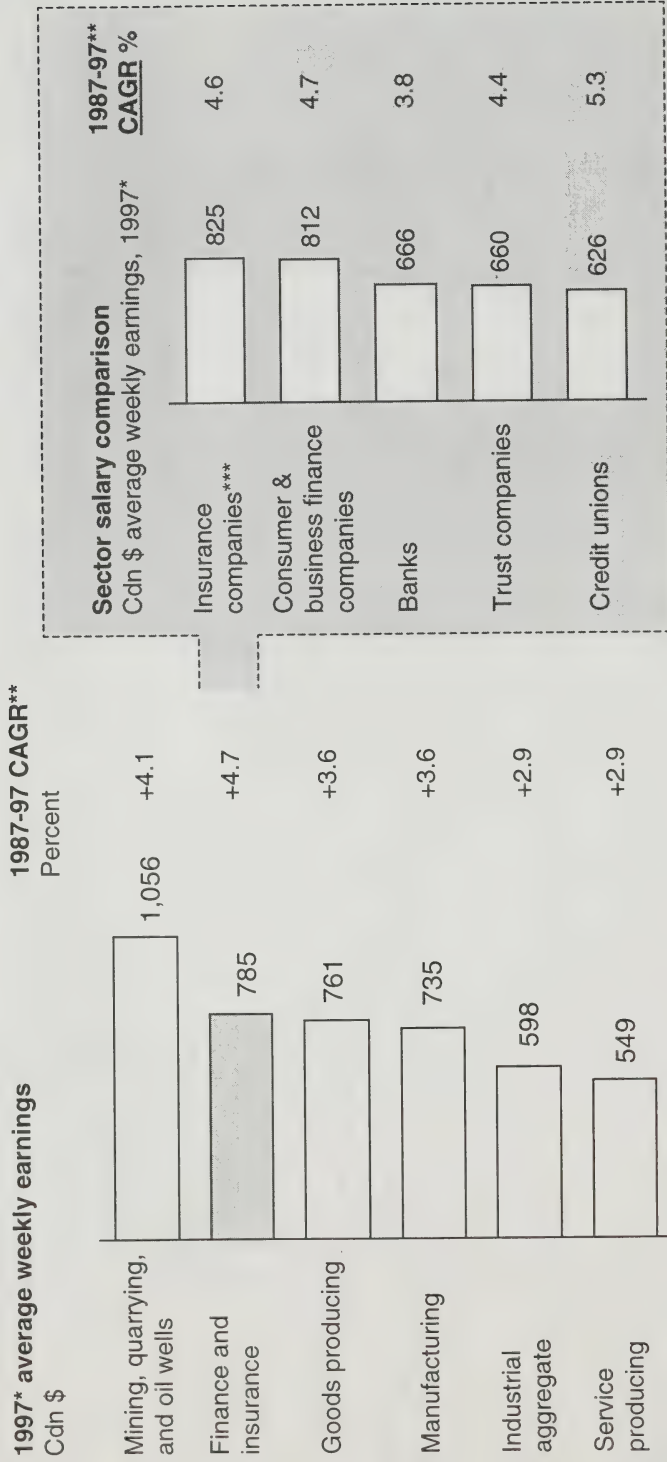
Employment levels by sector 1997
Thousands of employees



* 1987-96: December; 1997: November figures

Source: Statistics Canada

FINANCE SECTOR WAGES ARE COMPARATIVELY ATTRACTIVE



* Average of 11 months 1997

** December 1987-November 1997

*** Excluding agencies

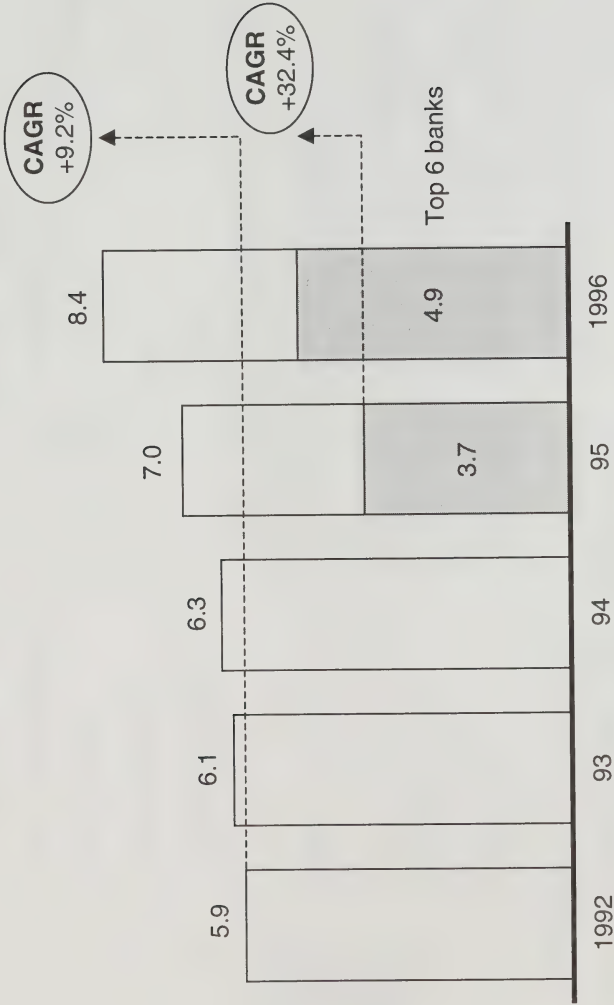
Source: Statistics Canada

Public good

PUBLIC FINANCIAL INSTITUTIONS CONTRIBUTE SIGNIFICANTLY TO CANADA'S TAX BASE

Taxes paid by all financial institutions

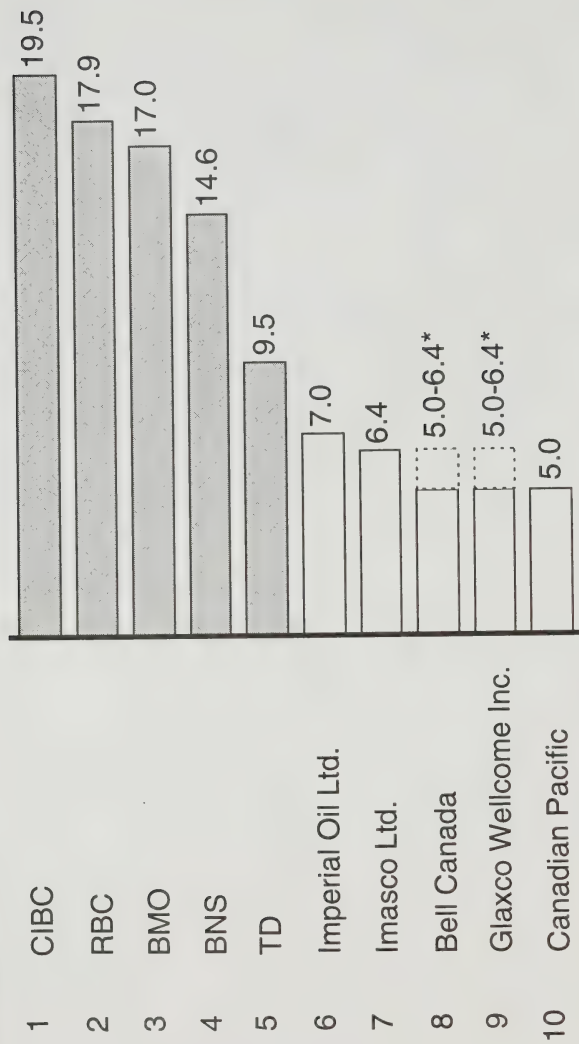
Cdn \$ Billions



Source: The Conference Board of Canada; CBA

BANKS ARE TOP CORPORATE GIVERS IN THE COMMUNITY**Top 10 corporate philanthropists**

1997 donation budget, Cdn \$ Millions

Ranking

* Not disclosed

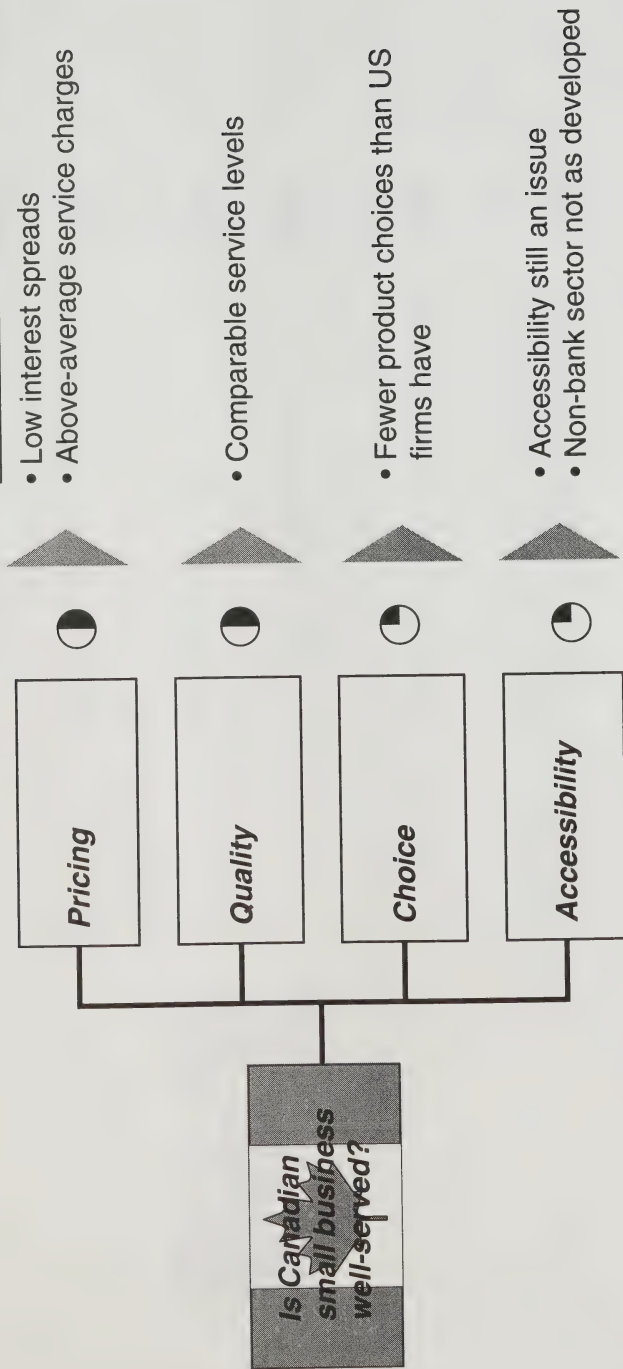
Source: Member survey by Canadian Centre for Business in the Community

Customers

SMALL BUSINESSES RECEIVE SUBPAR SERVICE

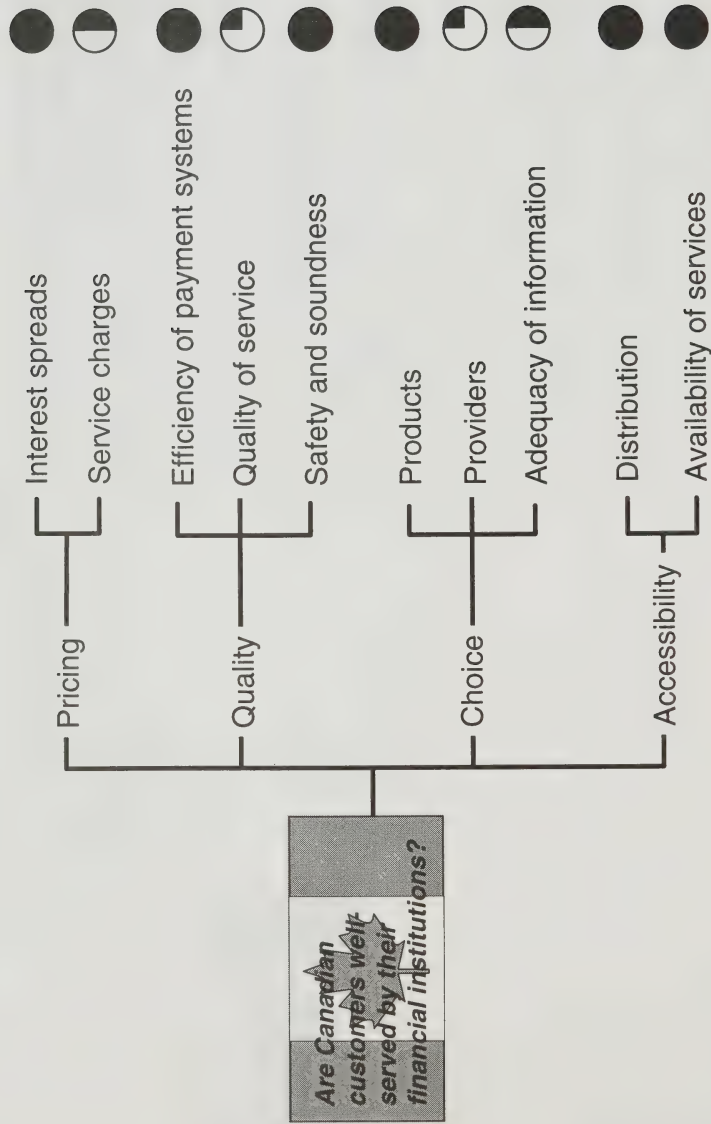


Observations



Source: Refer to Chapter 6 for further analysis

FOR RETAIL CUSTOMERS, THE STORY IS POSITIVE WITH ROOM FOR IMPROVEMENT IN SOME AREAS



Canada's size

Industry players

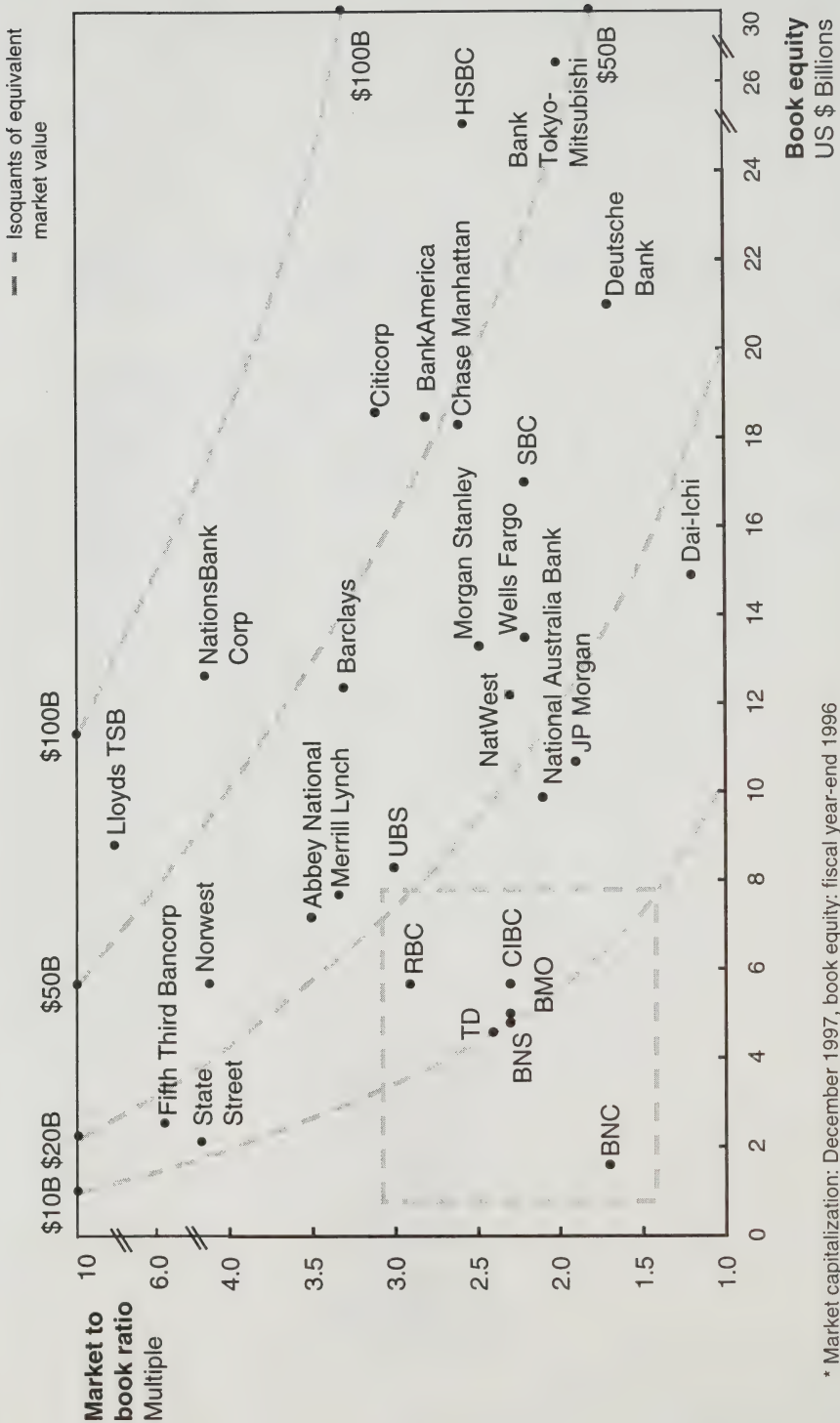
Business lines

Canadian performance indicators



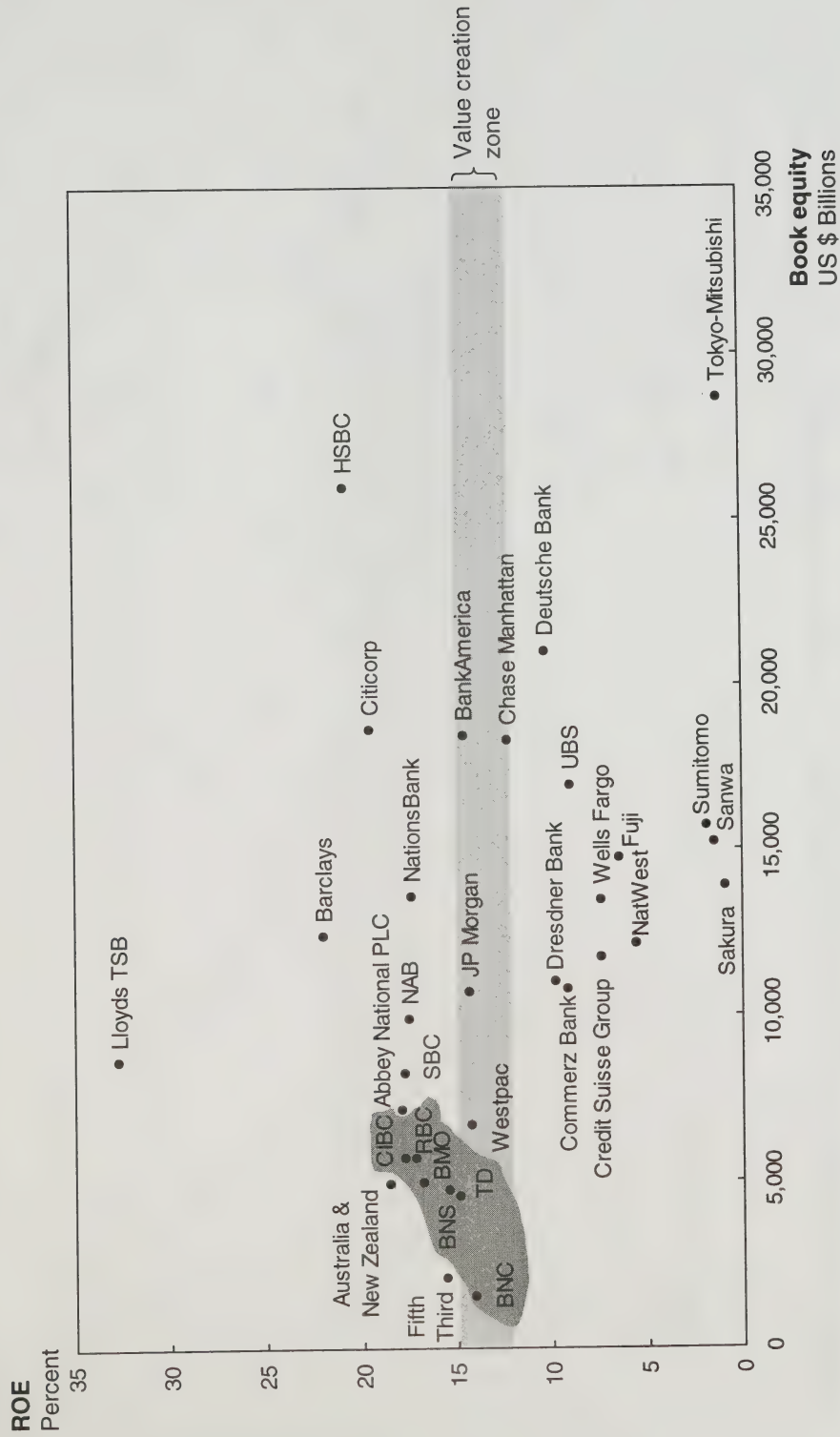
International comparisons

CANADIAN BANKS ARE NEITHER HIGH PERFORMERS NOR LARGE IN SIZE 1997*

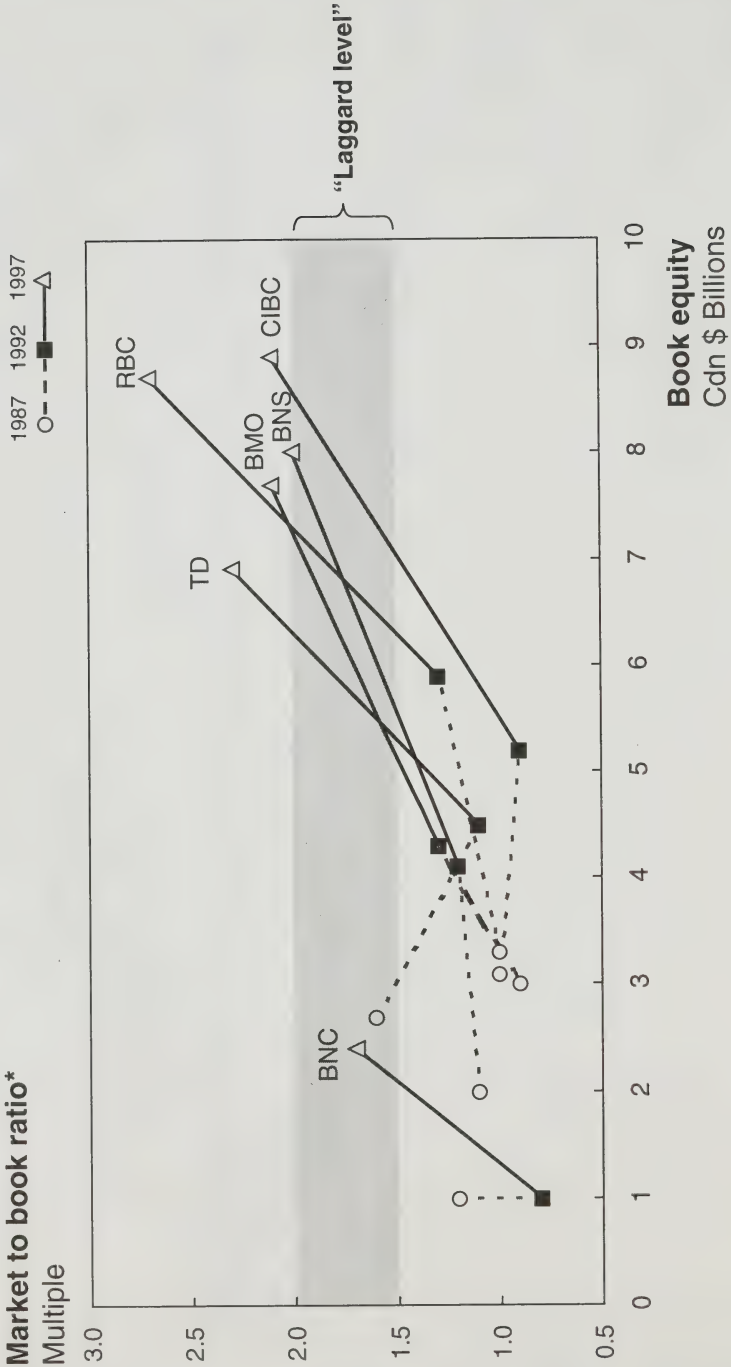


* Market capitalization: December 1997, book equity: fiscal year-end 1996

CANADIAN BANKS ARE BARELY IN THE "VALUE CREATION" ZONE



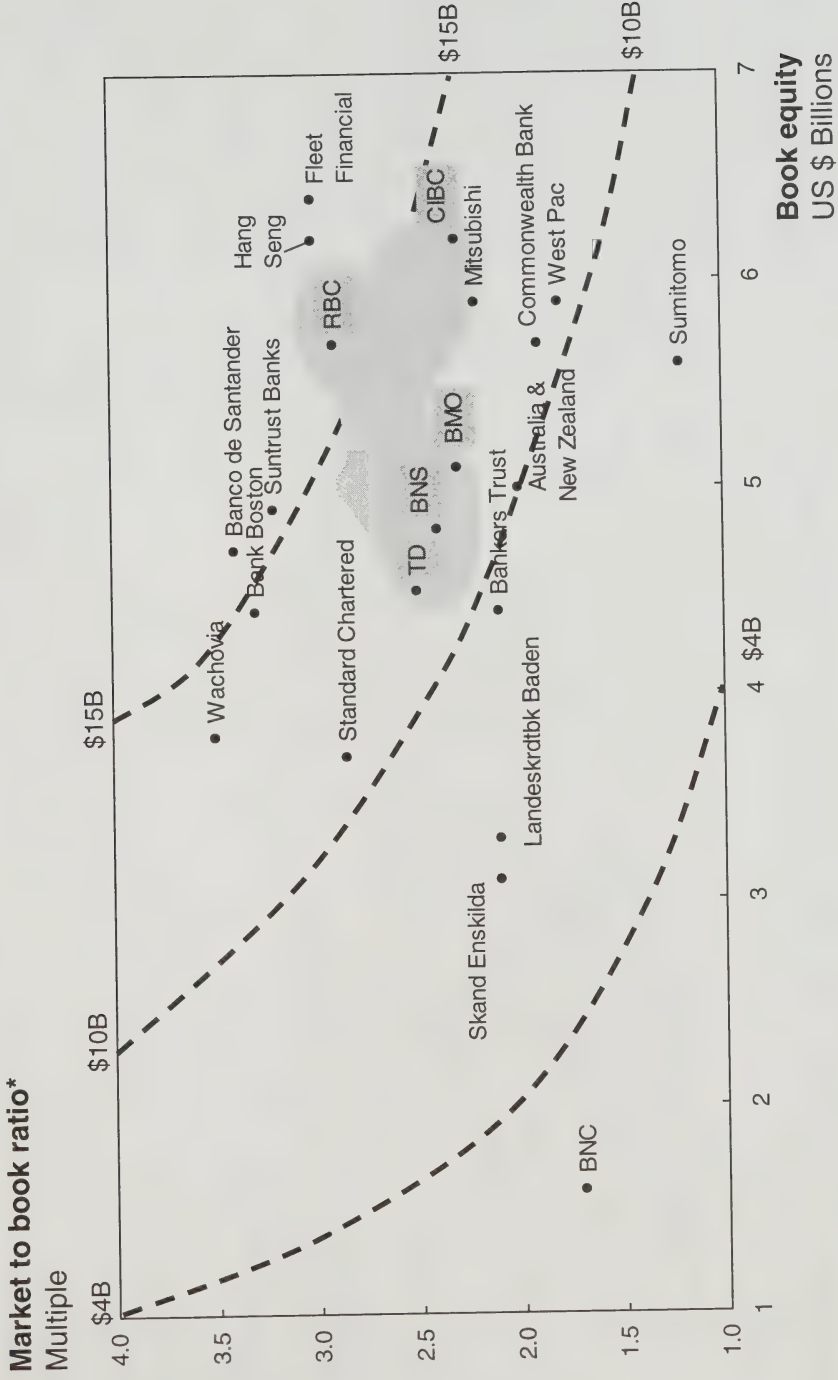
CANADIAN BANKS' RATIOS HAVE BEEN MOVING IN THE RIGHT DIRECTION



* Market capitalization year-end; book equity fiscal year-end
 Source: TSE review; Compustat; McKinsey & Company analysis

CANADIAN BANKS ARE NOT ALONE

1997*

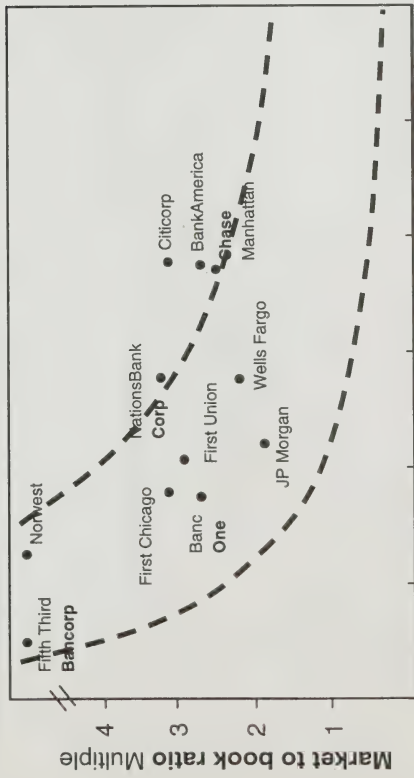


* Market capitalization Dec 1997; book equity fiscal year-end 1996

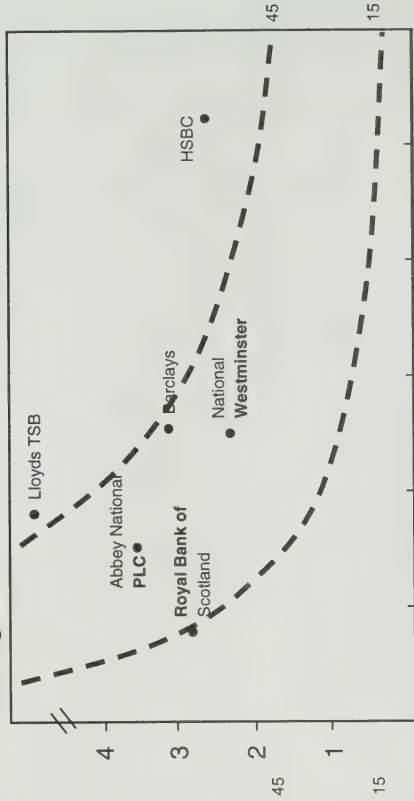
INTERNATIONAL MARKET TO BOOK RATIO COMPARISON

1997*

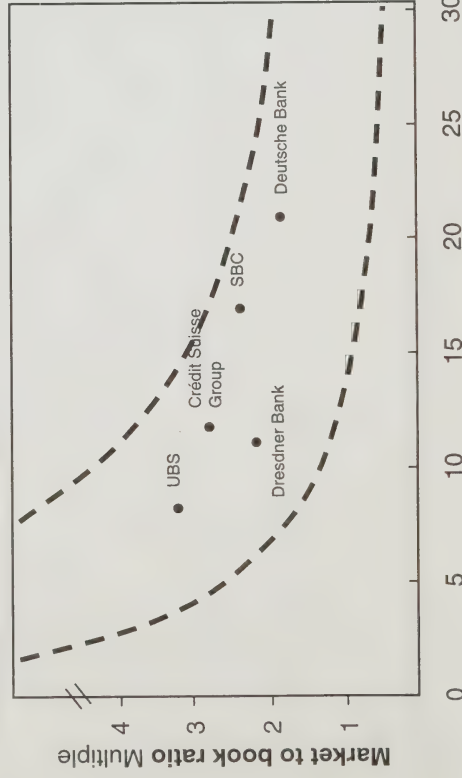
United States



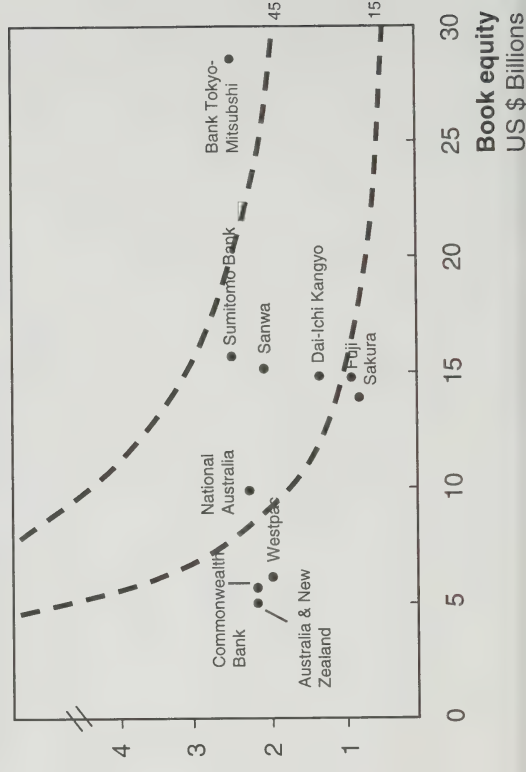
United Kingdom



Germany and Switzerland

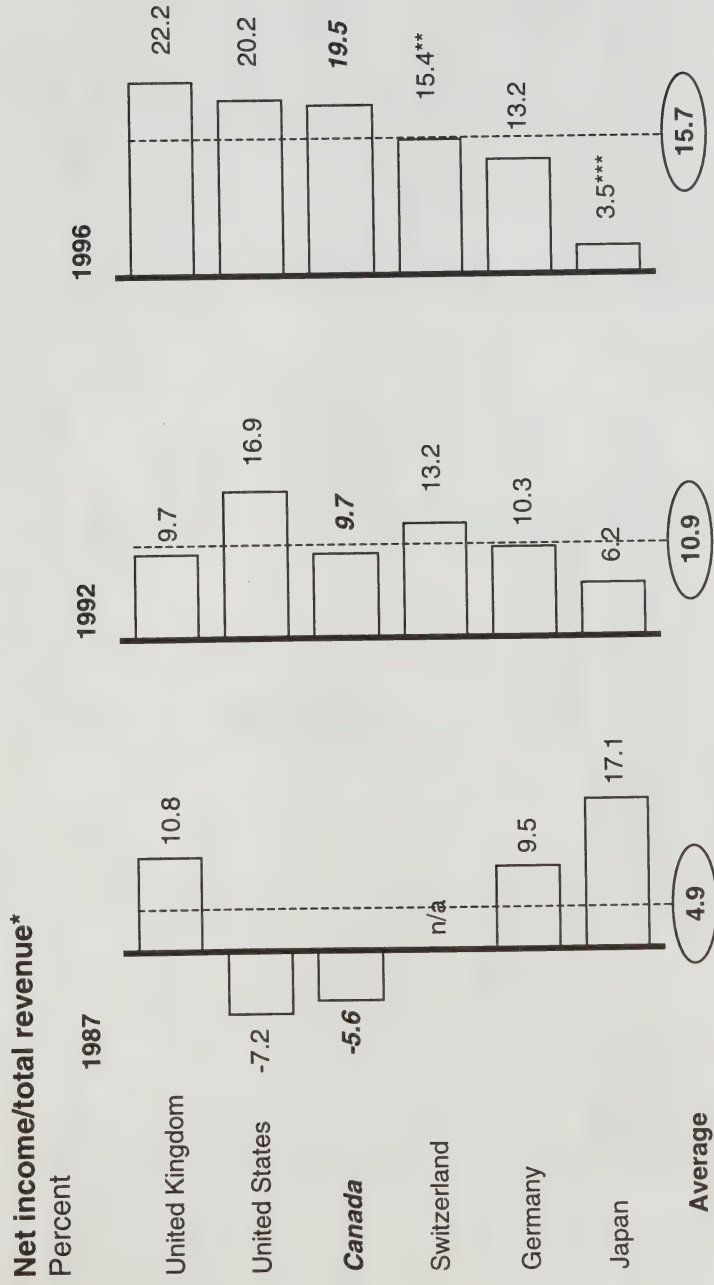


Australia and Japan



* Market capitalization: December 1997, book equity fiscal year-end 1996

OVERALL PROFITABILITY OF CANADIAN BANKS HAS IMPROVED

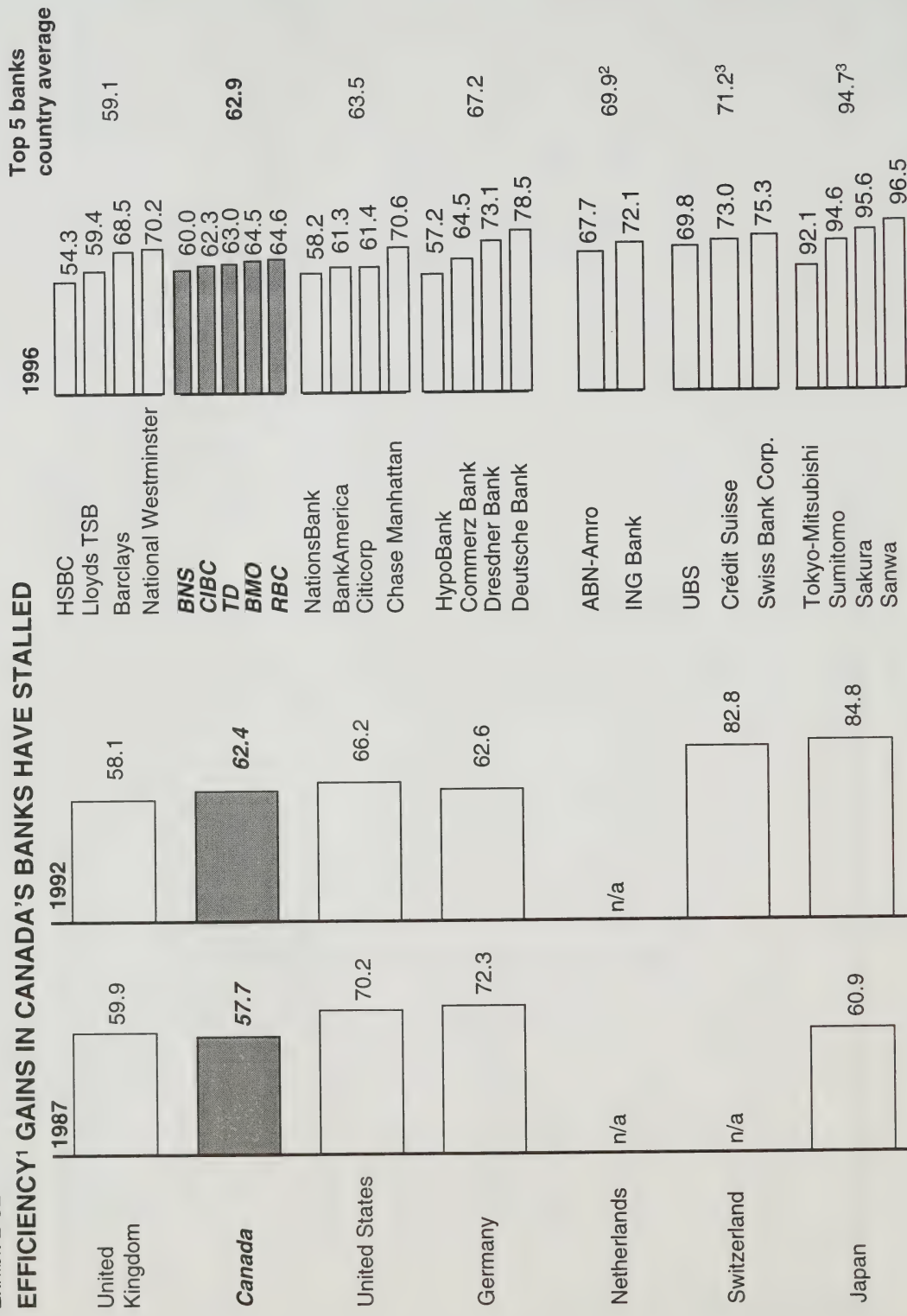


* Average of Top 5 banks per country, except UK 1987 average of Top 4

** Based on net income before 1996 special provision for bad loans, average of Top 4

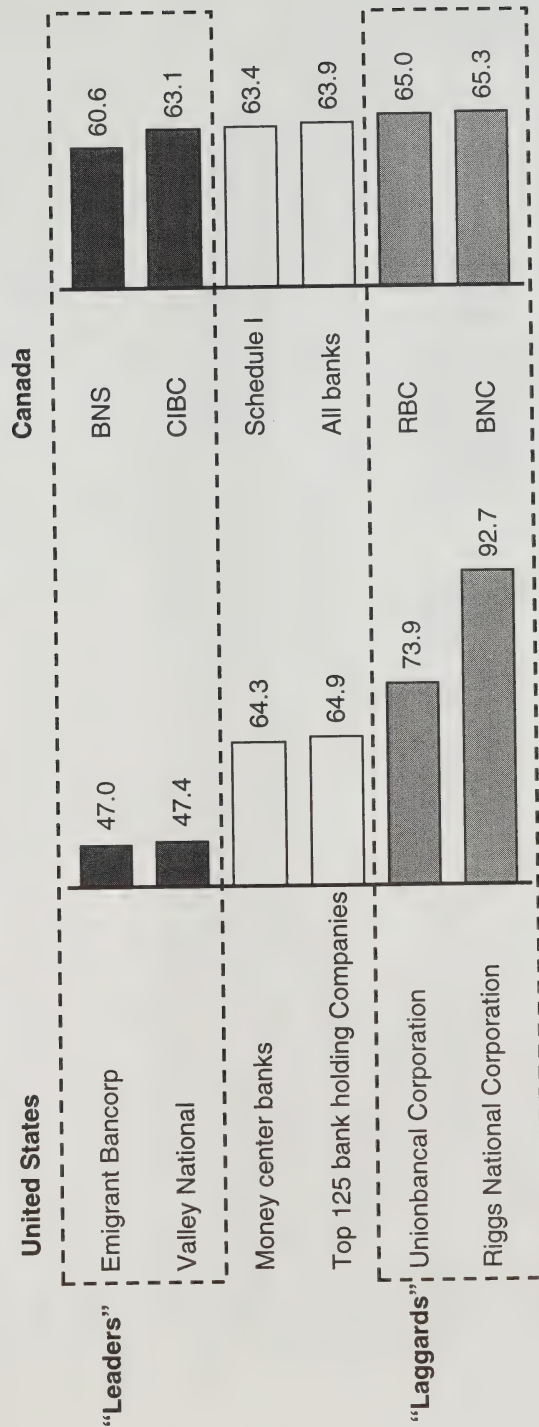
*** Excluding Dai-ichi

Source: McKinsey & Company Global FIG Practice

EFFICIENCY¹ GAINS IN CANADA'S BANKS HAVE STALLED¹ Non-interest expense divided by total income² Average of Top 2

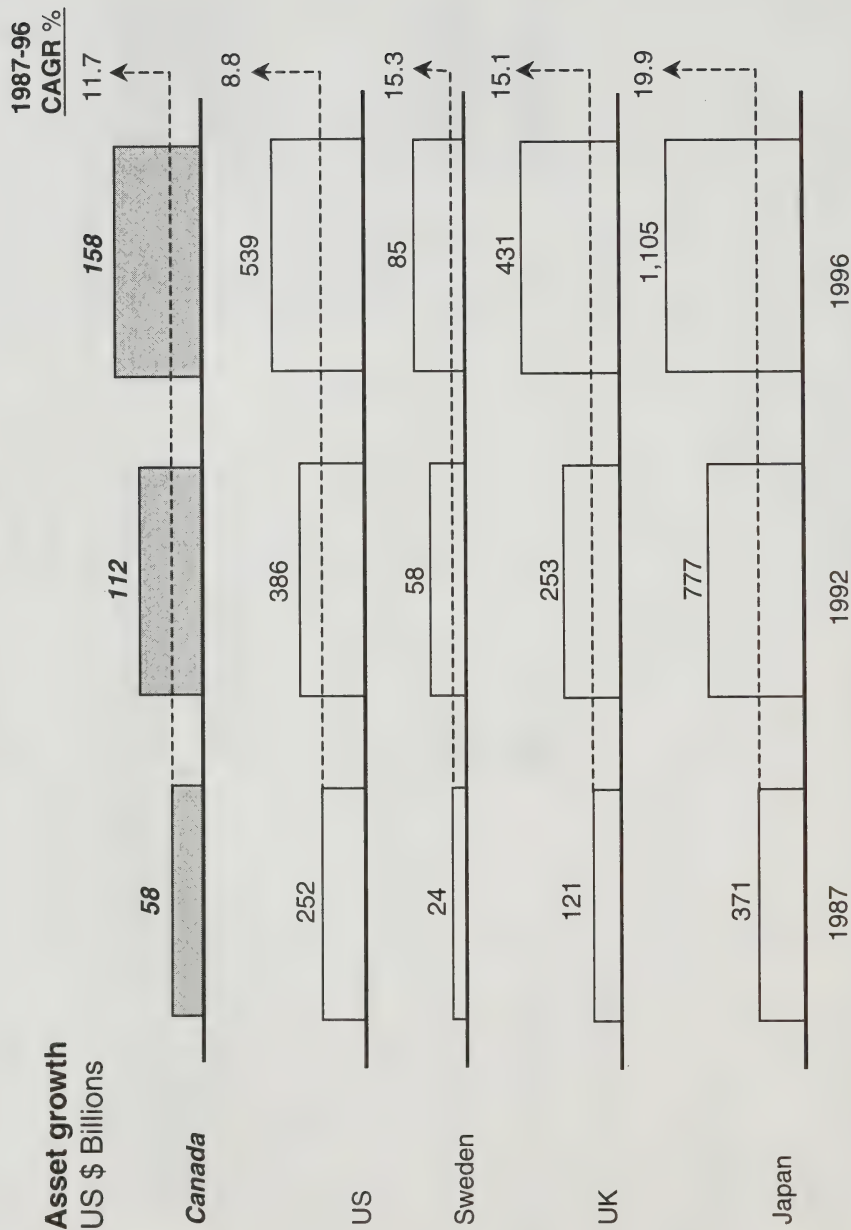
LITTLE PERFORMANCE VARIATION EXISTS AMONG CANADA'S EFFICIENCY LEADERS AND LAGGARDS

Average 1992-96
Percent

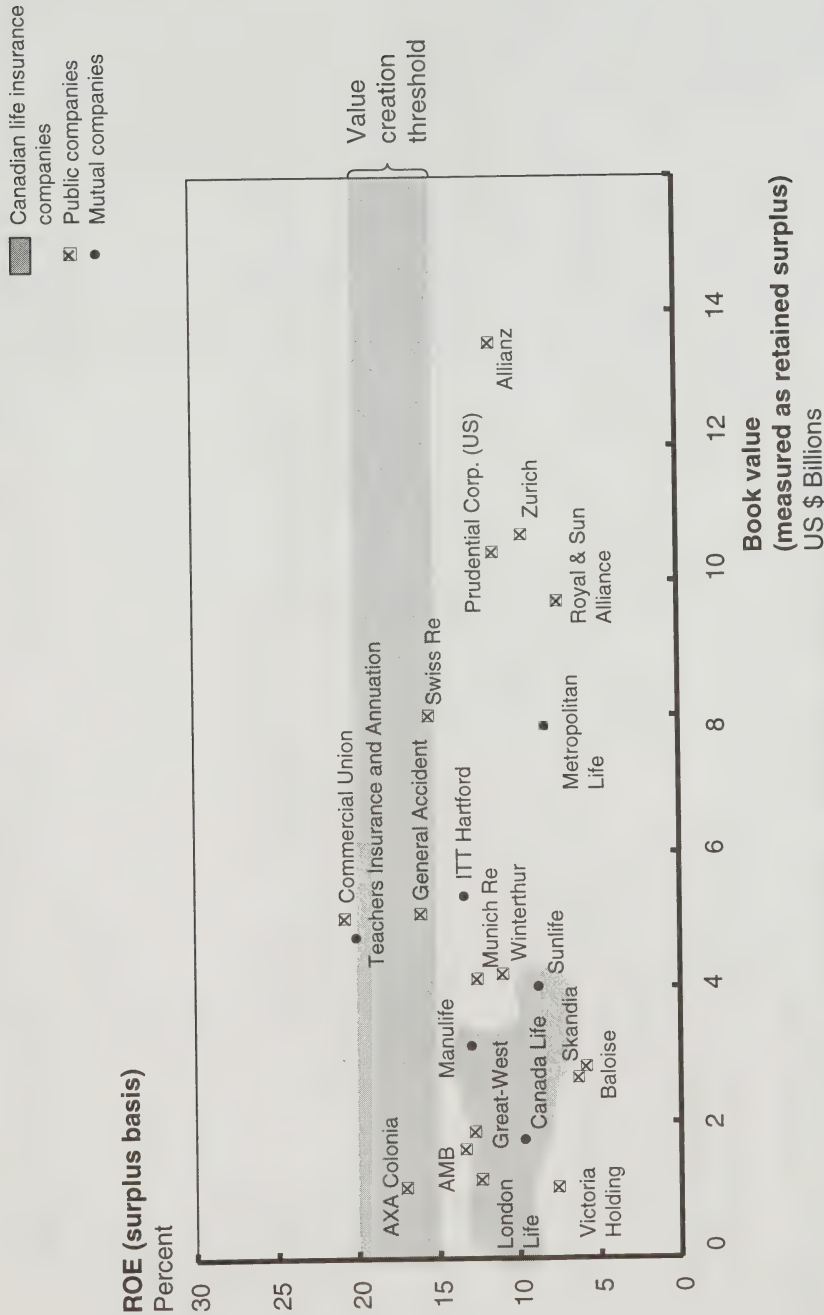


Source: OSFI; The Financial Post; McKinsey & Company analysis

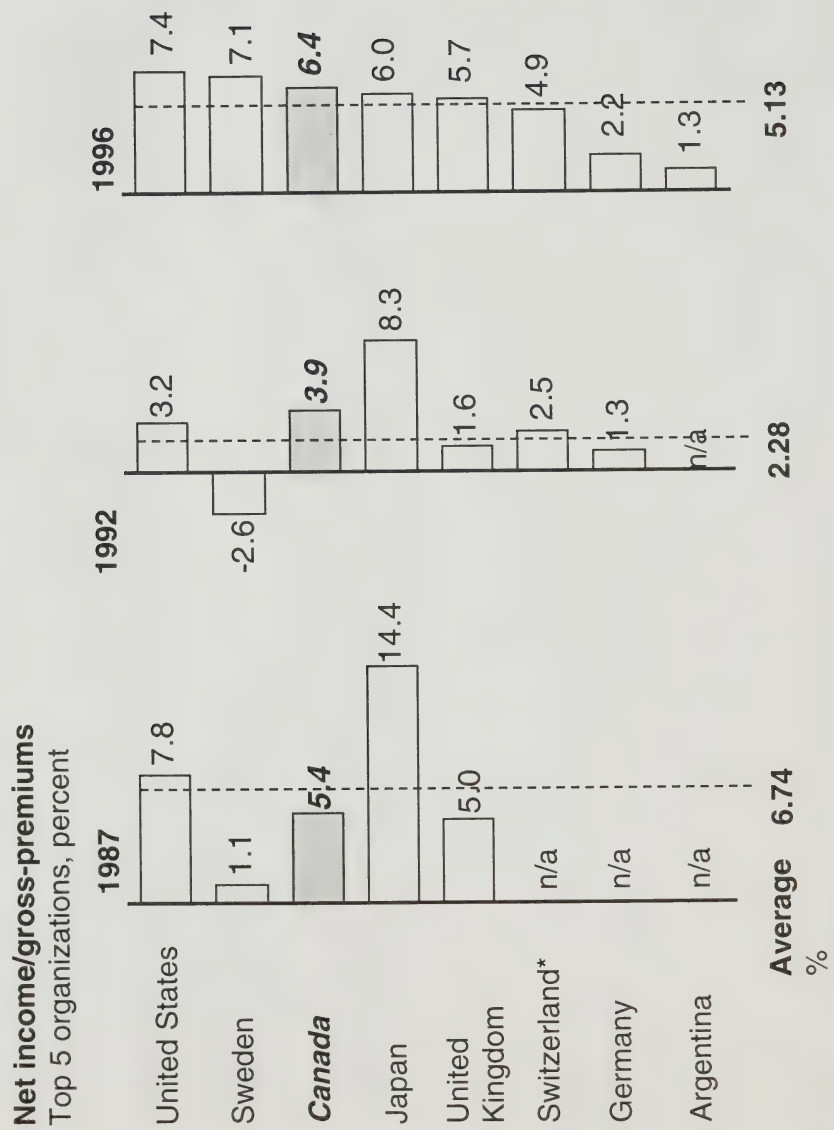
CANADIAN INSURERS 10-YEAR GROWTH REMAINS MIDDLE OF THE PACK



MANY INSURERS, INCLUDING CANADA'S, ARE NOT CREATING VALUE **1996**



CANADIAN INSURERS PROFITABILITY IS STILL NOT WORLD-CLASS
DESPITE RECENT IMPROVEMENTS

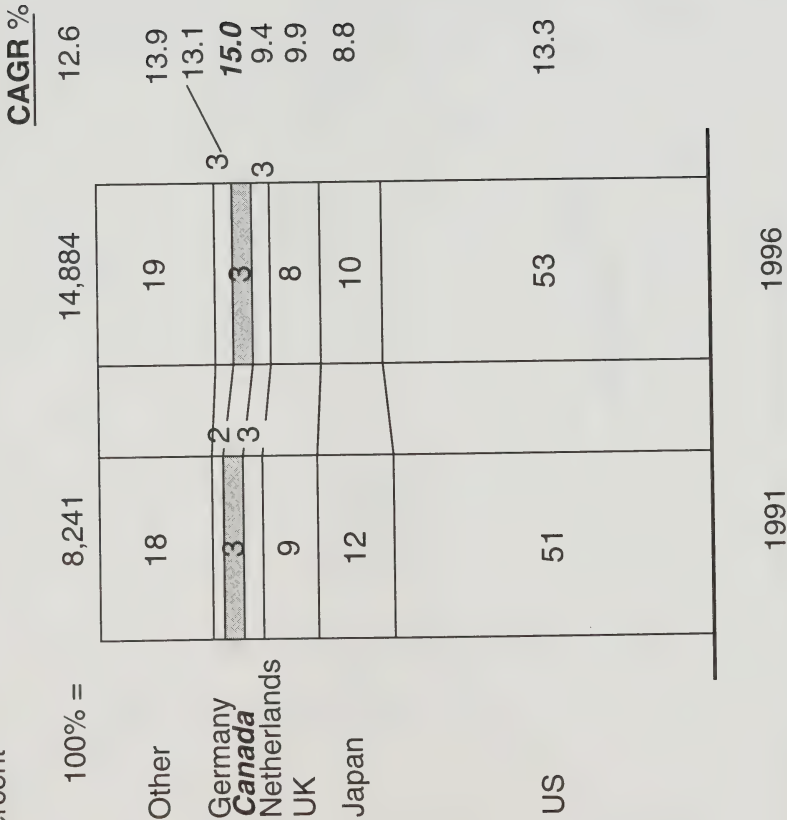


* Average of Top 4 organizations
Source: McKinsey & Company Global FIG Practice

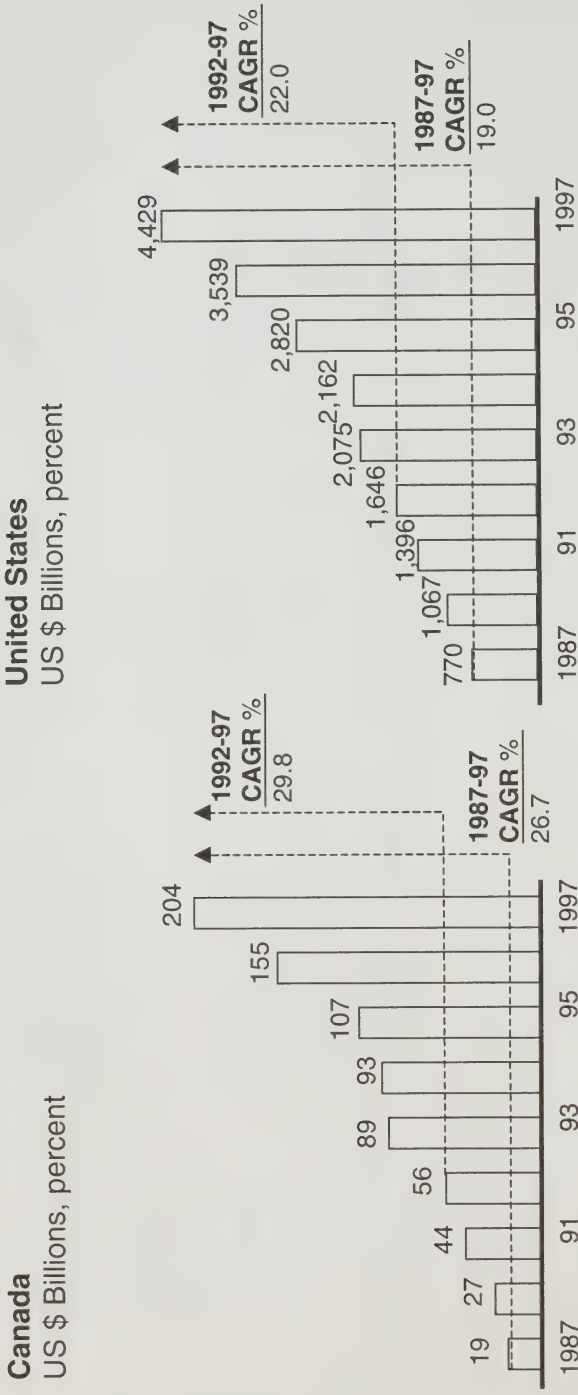
THE GLOBAL AND CANADIAN ASSET MANAGEMENT MARKETS ARE GROWING RAPIDLY

Pension and mutual fund assets

US \$ Billions, percent

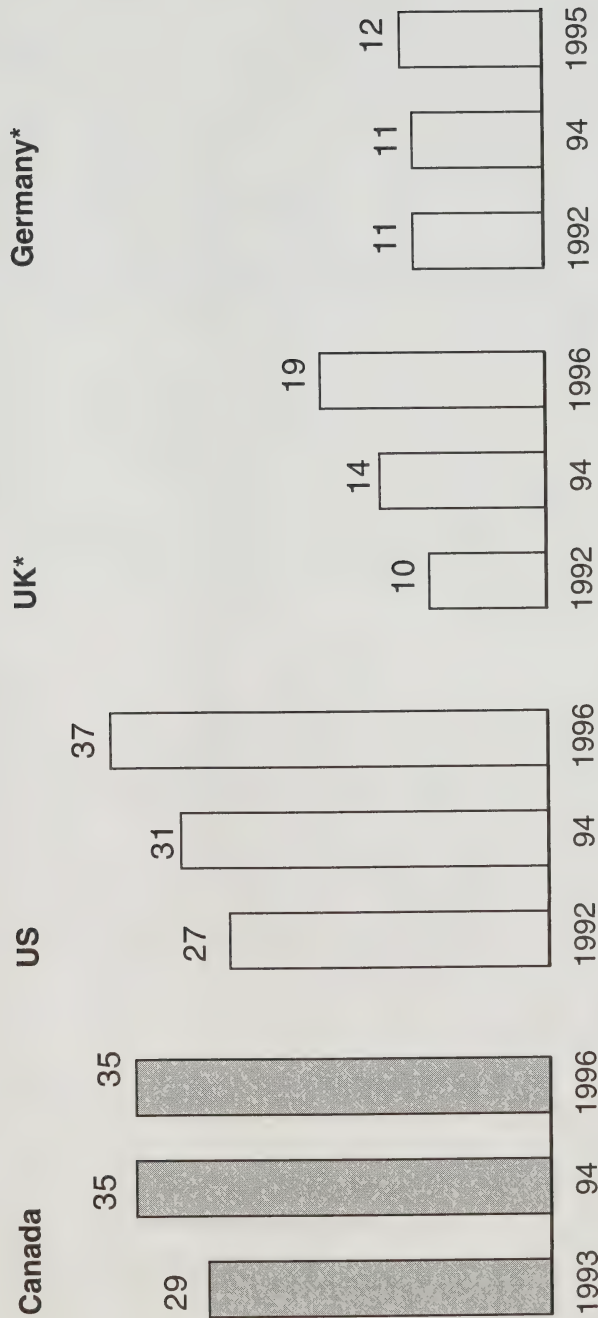


CANADIAN MUTUAL FUND ASSETS CONTINUE THEIR HIGH GROWTH



MUTUAL FUND OWNERSHIP IS HIGH IN NORTH AMERICA

Households owning mutual funds
Percent



* Estimates based on data compiled on different bases – likely to be somewhat overstated

Source: ICI; McKinsey & Company analysis

LEADING PLAYERS IN GLOBAL ASSET MANAGEMENT ARE SEVERAL TIMES THE SIZE OF CANADA'S LARGEST ASSET MANAGERS

Ranking of the world's largest fund manager 1997*

1997 rank		Country	AUM US \$ Billions
1	Kampo Life	Japan	798
2	UBS/Swiss Bank Corp.	Switzerland	679
3	Fidelity Investments	US	516
4	Groupe AXA	France	497
5	State Street Global Advisors	US	386
6	Barclay's Global Investors	UK	385
7	Merrill Lynch/Mercury AM	US	382
8	Crédit Suisse	Switzerland	376
9	Nippon Life Insurance	Japan	322
10	Prudential Insurance	US	272
11	Capital Group	US	260
12	Mellon Bank Corp.	US	259
13	Zenkyoren	Japan	237
14	Dai-ichi Mutual Life	Japan	232
15	Deutsche Bank	Germany	231
52	Sun Life	Canada	103
71	Desjardins Laurentian	Canada	83
151	Caisse de Dépôt	Canada	42
157	Royal Bank	Canada	40
174	Manulife Financial	Canada	36

* Figures include internal institutional (e.g., insurance) assets

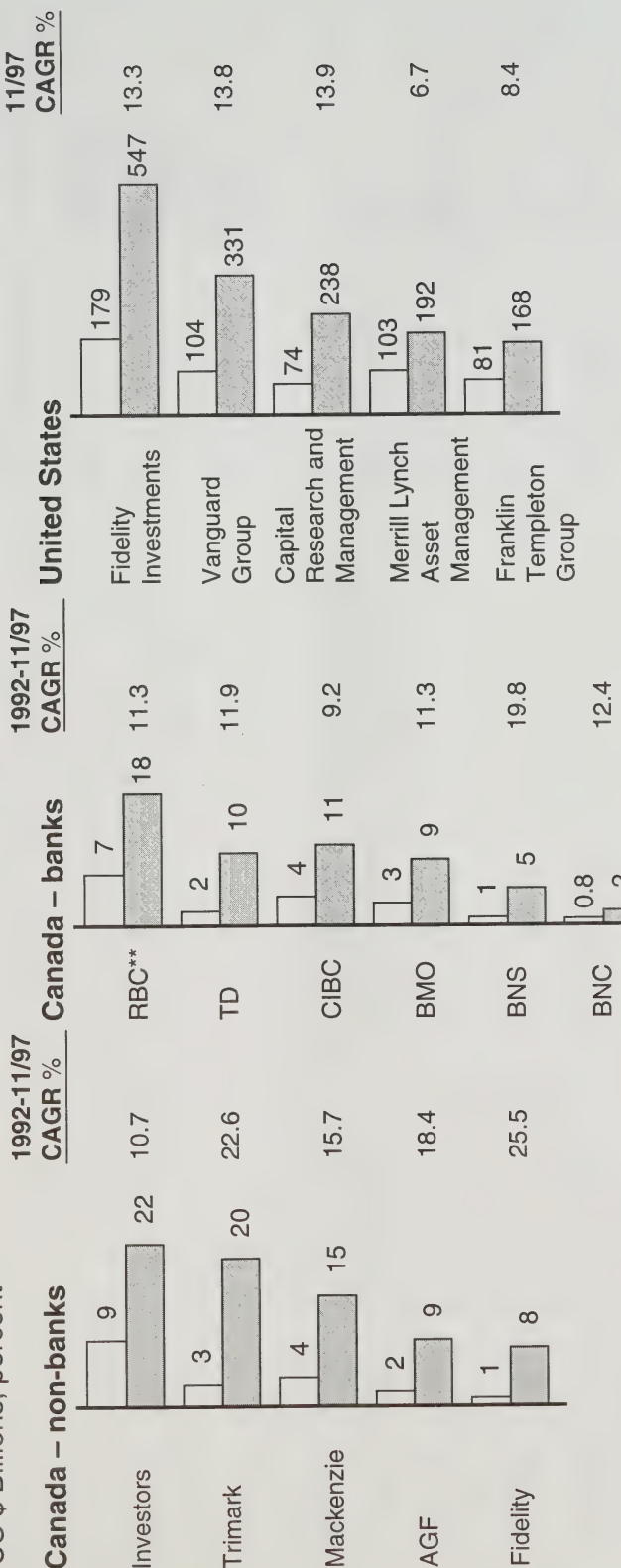
Source: *Institutional Investor*, Euromoney; Pensions and Investments; McKinsey & Company analysis

DOMESTIC INDEPENDENT MUTUAL FUND MANAGERS ARE GROWING MORE STRONGLY THAN BANK-OWNED COMPETITION

1992*
November 1997

Assets under management

US \$ Billions, percent



* US January 31, 1993; Canada December 31, 1992

** Royal and Royal Trust 1992

Source: IFIC; ICI

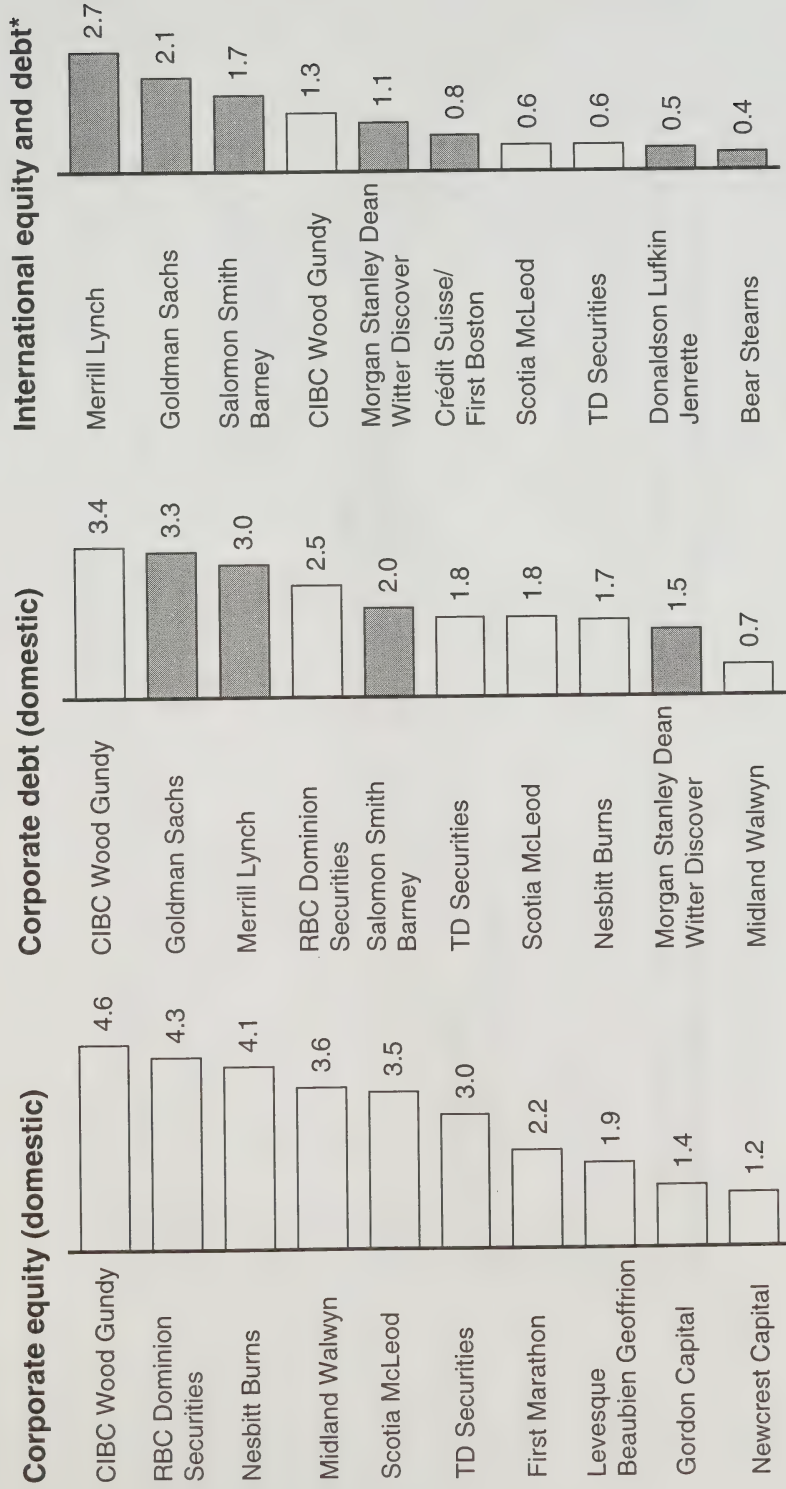
Chapter 3 Exhibits

FOREIGN INVESTMENT BANKS ARE MAKING INROADS INTO CANADA

Underwriters – bonus credit basis, 1997

Cdn \$ Billions

■ US-based players

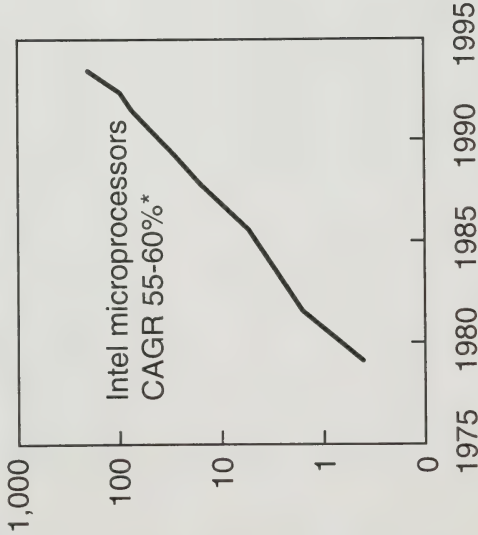


* Canadian issuers of international equity and debt

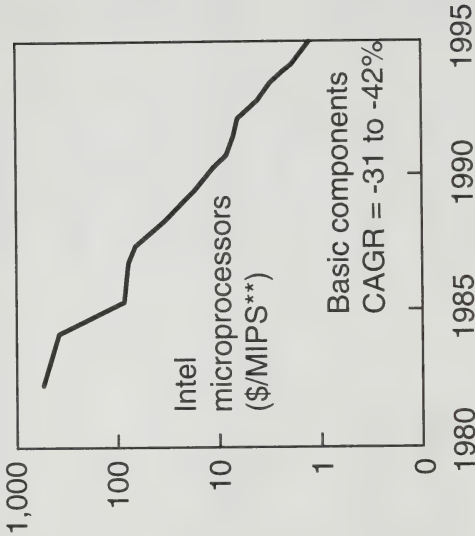
Source: *The Financial Post*

COMPUTING POWER IS RISING

Processor performance climbs...
Indexed test results on integer calculations



...while prices continue to decline
Price per performance unit – 1995 dollars

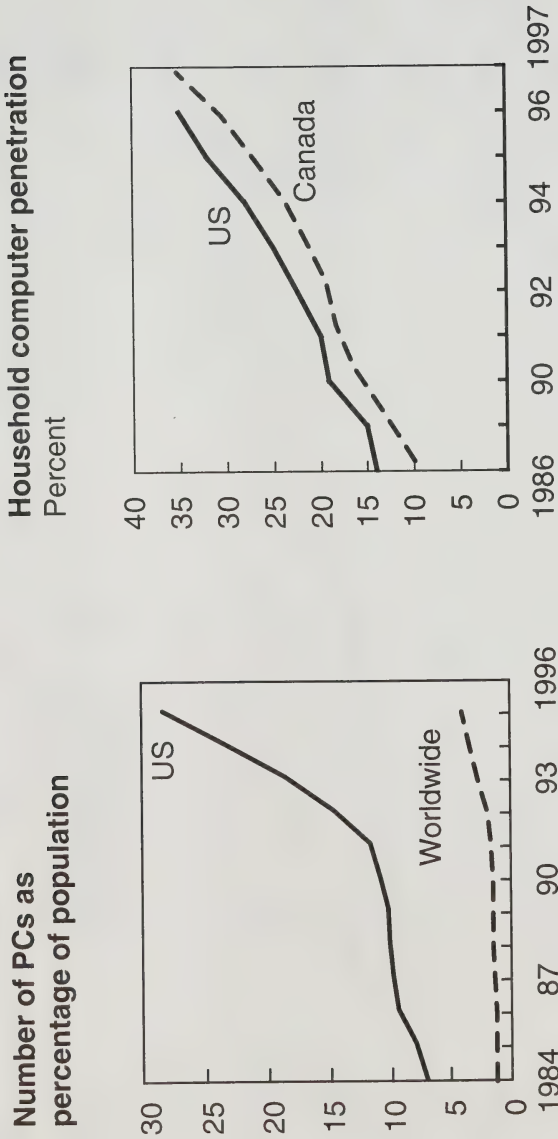


* 50% due to microprocessor and 5-10% due to compiler improvements

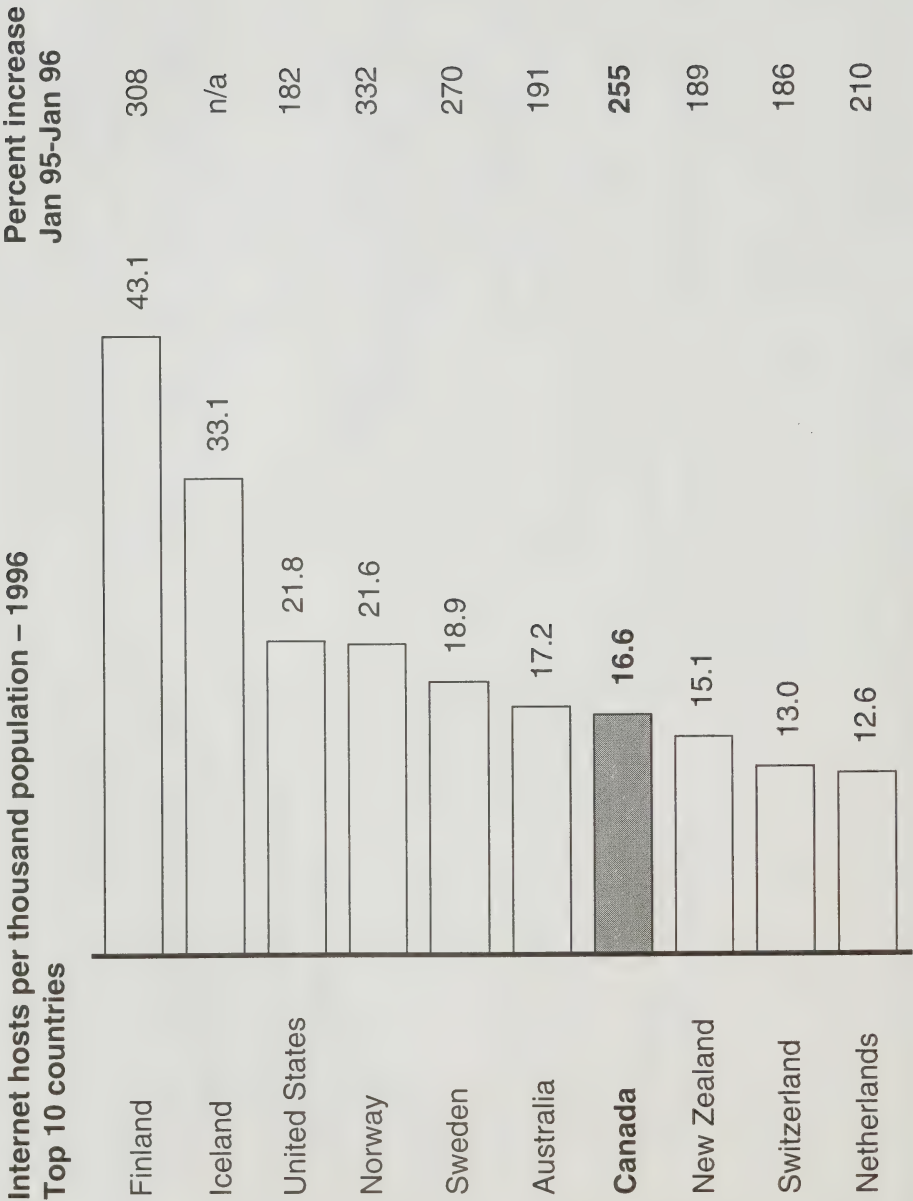
** Million instructions per second

Source: McKinsey & Company Global Forces Initiative; "RISC vs. CISC," *Microprocessor Report*, January 23, 1995; "Systems performance," *Dataquest*, 1993; "Rigid disk storage," *Dataquest*, 1994; *DRAM memory*, Bernstein Research, 1980-93; *Dataquest*, 1994-95

PC PENETRATION IS INCREASING IN CANADA AND THE US

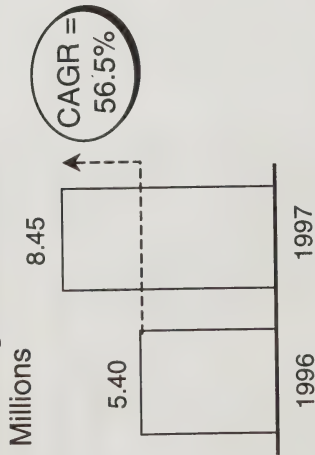


CANADA IS THE NO. 7 WIRED COUNTRY WORLDWIDE

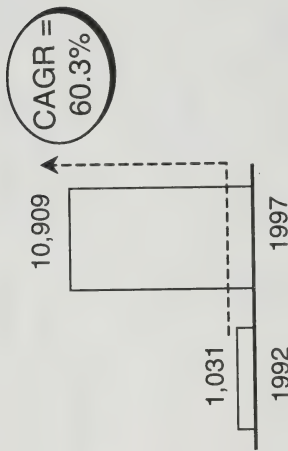


USE OF ELECTRONIC/REMOTE CHANNELS HAS GROWN SIGNIFICANTLY

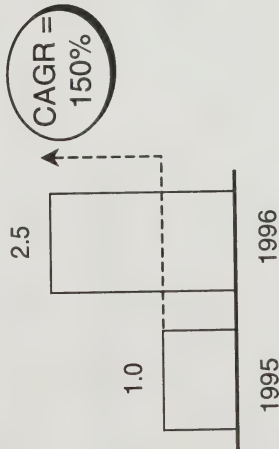
Monthly telephone banking transactions*



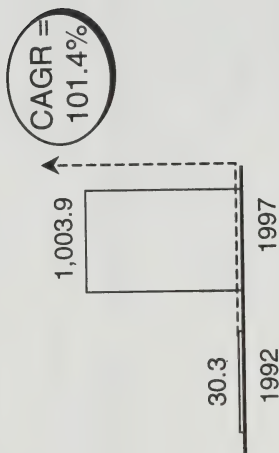
EFT/POS terminals
Per million population



Telephone banking transactions
Percentage of transactions



EFT/POS terminal transactions
Millions

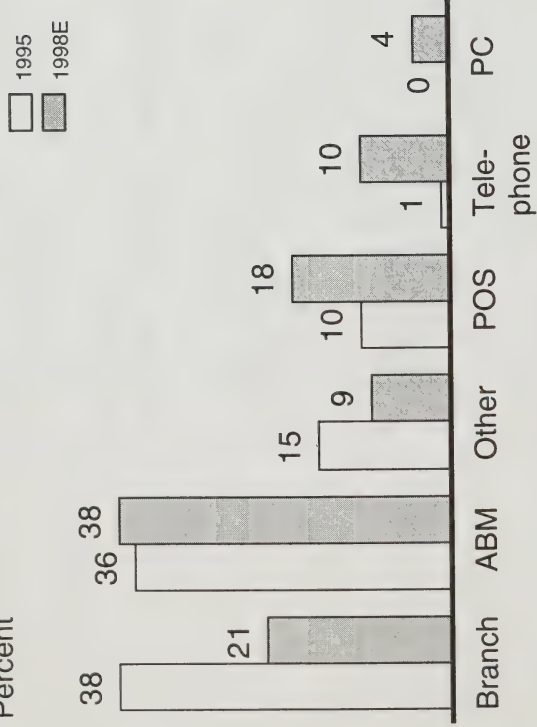


* For RBC, TD, CIBC for the months of July 96 and July 97

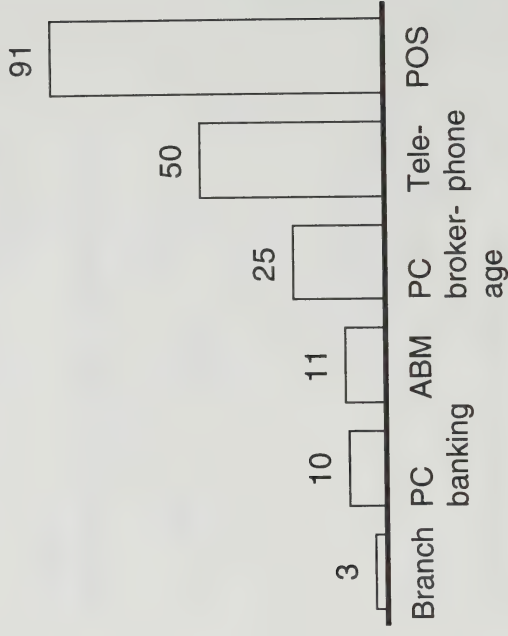
THE IMPORTANCE OF NON-TRADITIONAL DELIVERY CHANNELS IS INCREASING

CANADIAN EXAMPLE

Retail transactions by delivery channel
Percent



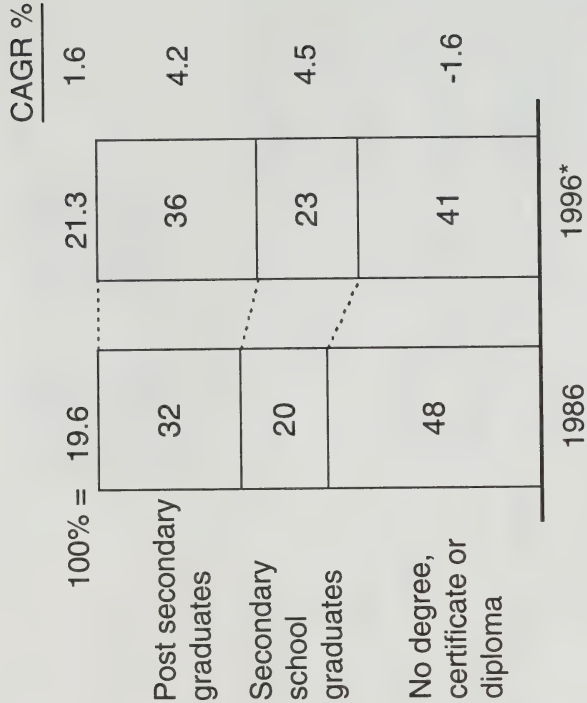
Annual increase in transaction volume
1994-96
CAGR percent



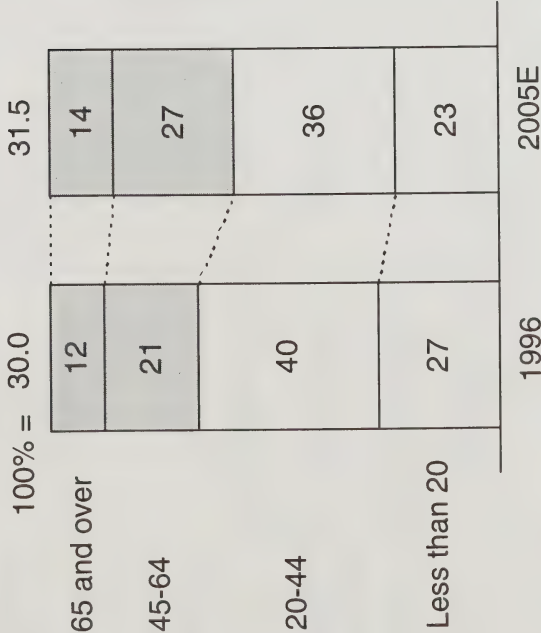
CANADIANS ARE GETTING OLDER AND ARE MORE EDUCATED

ESTIMATES

Population in Canada, 15 years and older by highest degree
Millions of people, percent

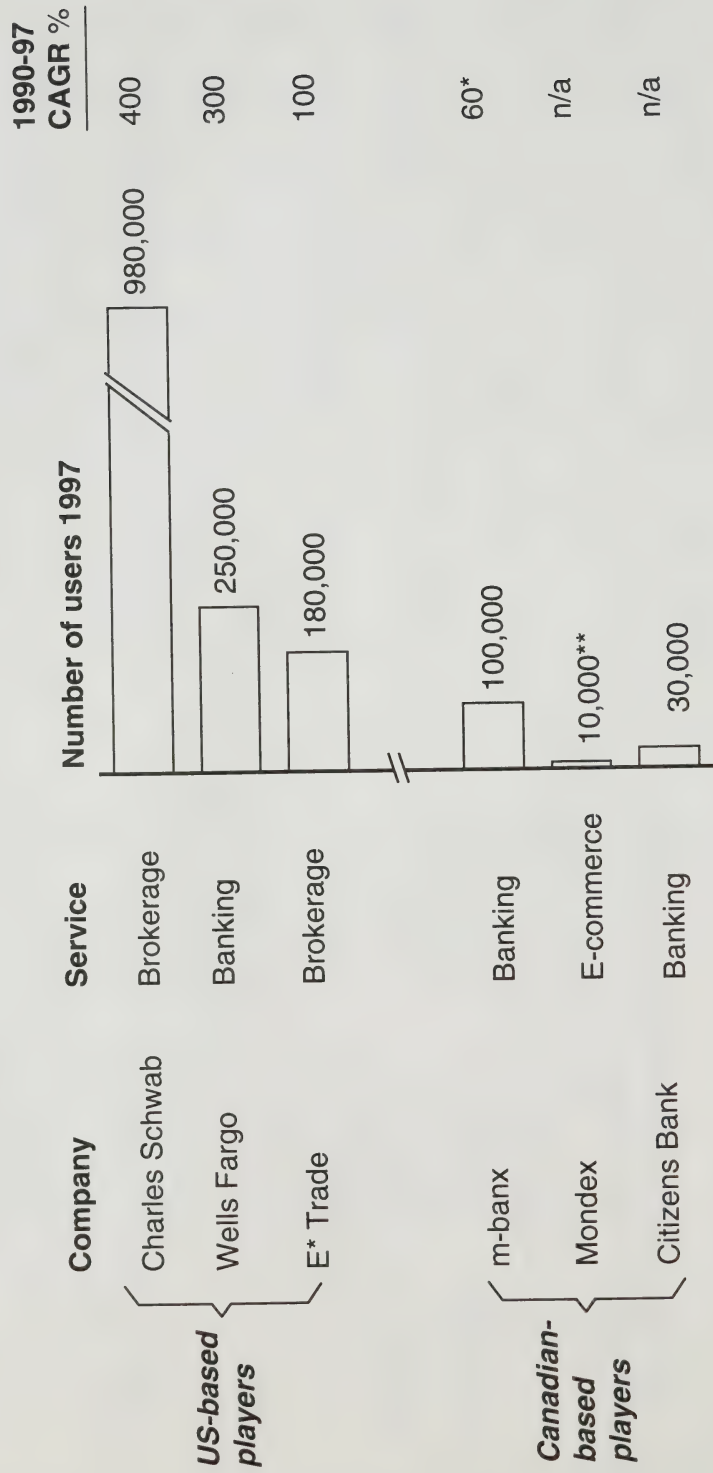


Age distribution of the Canadian population
Millions of people, percent



* 1996 census not available at publication date
Source: Ernst & Young Report; Statistics Canada; McKinsey & Company analysis

MANY CONSUMERS ARE USING NEW ENTRANTS' SERVICES TODAY



* Started in 1996

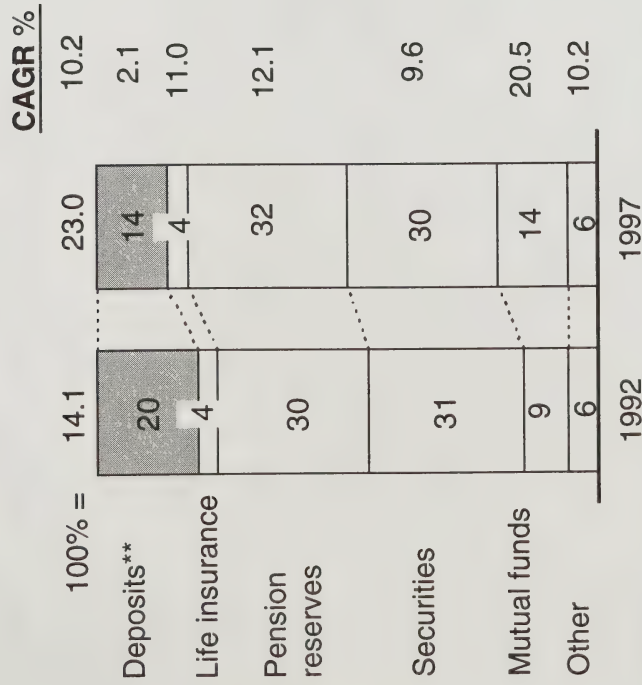
** Test market in Guelph

Source: Literature search; annual reports; McKinsey & Company analysis

CANADIAN HOUSEHOLDS ARE SHIFTING ASSET PORTFOLIOS

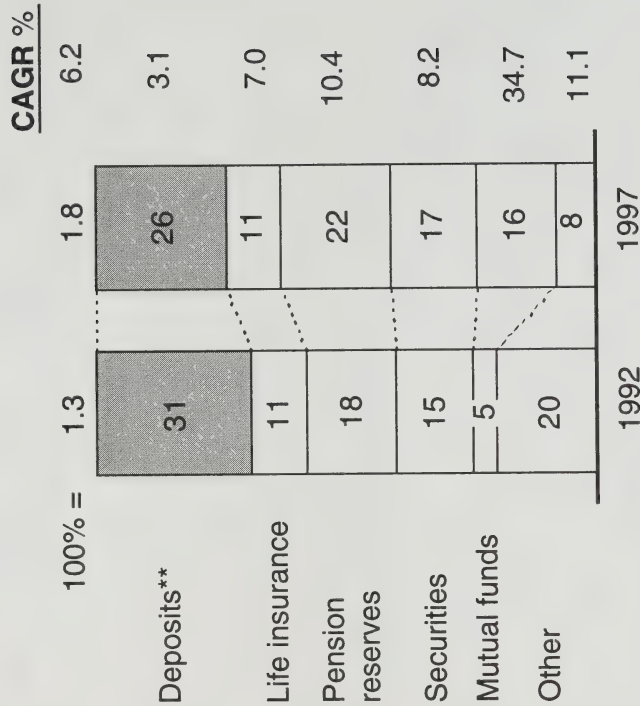
US household financial assets*

US \$ Trillions



Canada household financial assets

Cdn \$ Trillions



* Includes households and non-profit organizations

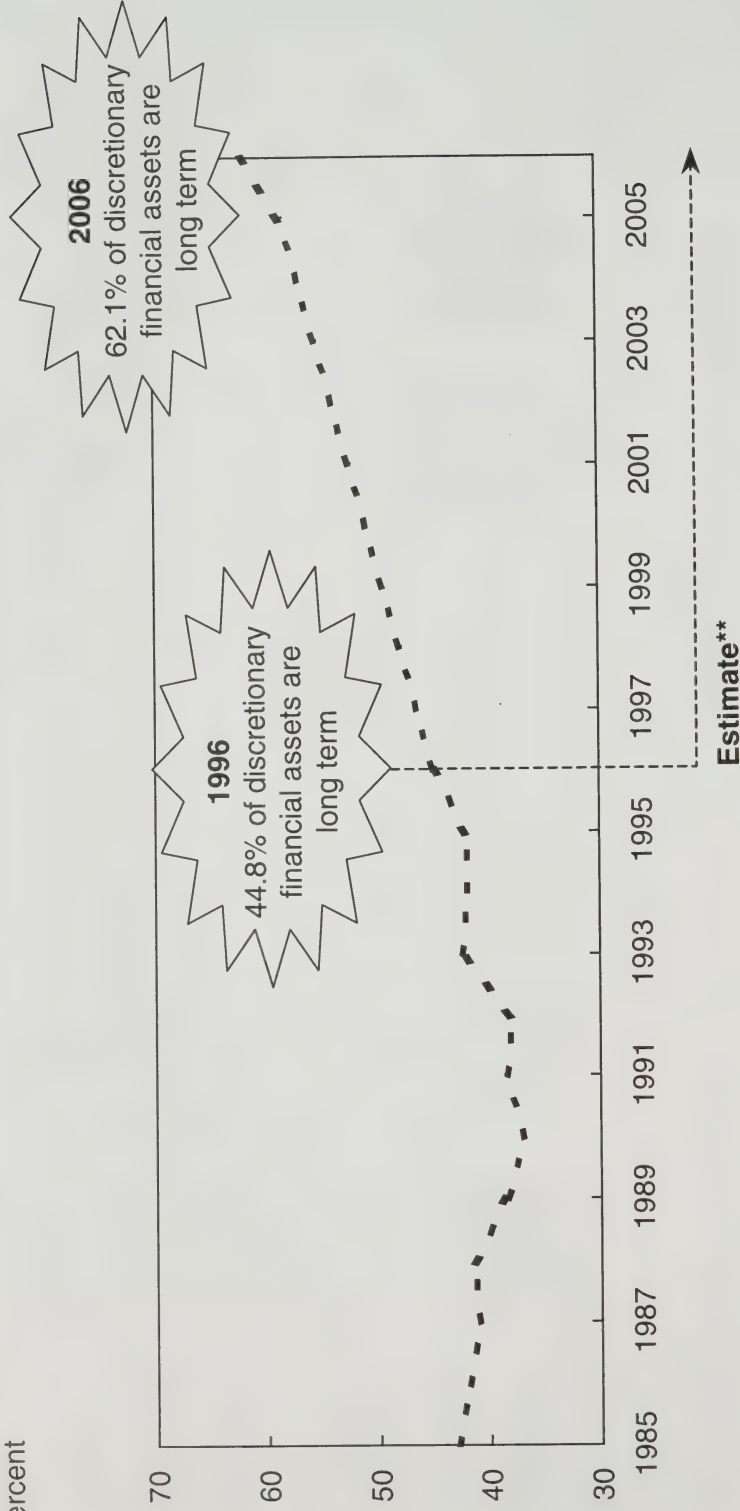
** Includes savings, checking, foreign currency/deposits

Source: US Federal Reserve Funds Flow; Bank of Canada Review; Ernst & Young report; McKinsey & Company analysis, National Balance Sheet Accounts

CANADIAN CONSUMERS ARE FORECAST TO TAKE ON MORE RISK

Long-term discretionary financial assets* as a portion of discretionary financial assets

Percent



* Include investments, life insurance, and pensions; discretionary assets are those where investors choose their asset allocation

** Based on GDP growth, customer surveys

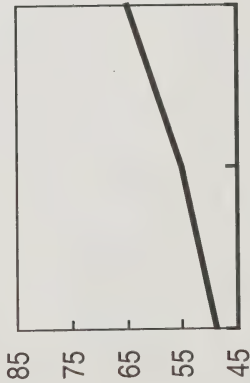
Source: Investor Economics, Inc., 1996

CONSUMER EXPECTATIONS OF PROVIDERS/STORES ARE INCREASING

Percent citing as important

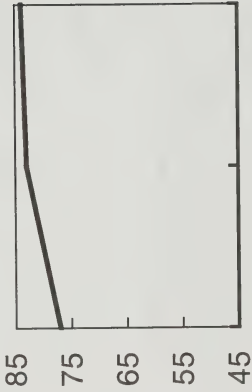
1. Convenience

Convenient store hours



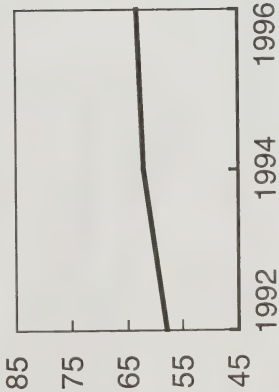
3. Price

Reasonable prices



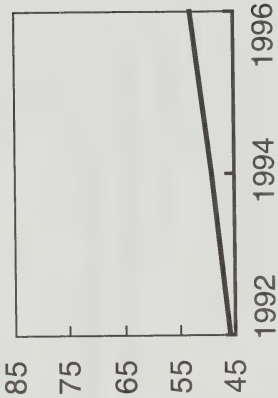
2. Choice

Always find what I want

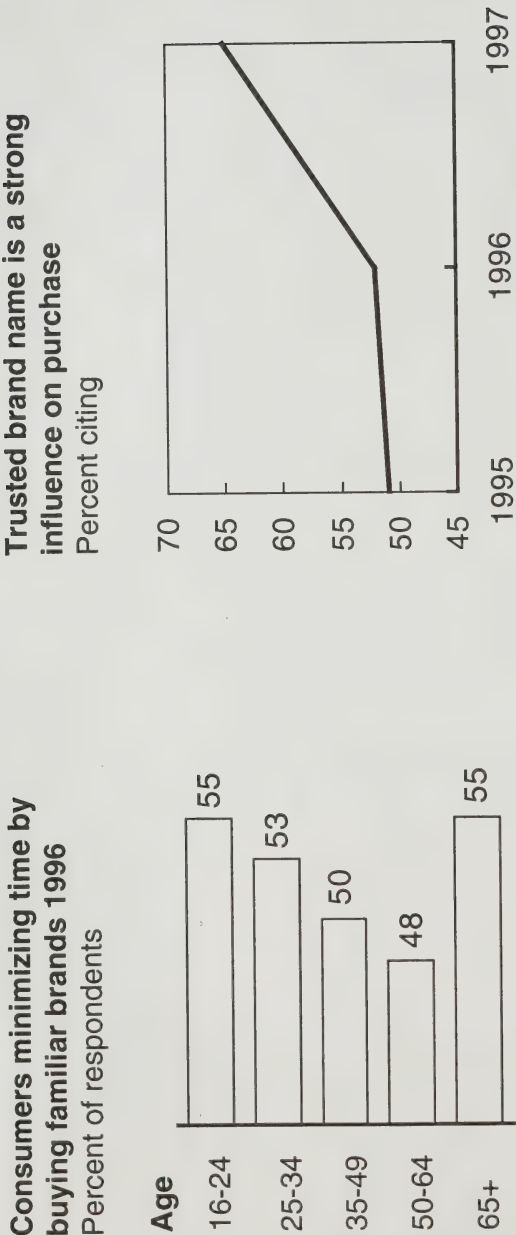


4. Experience

Pleasant atmosphere



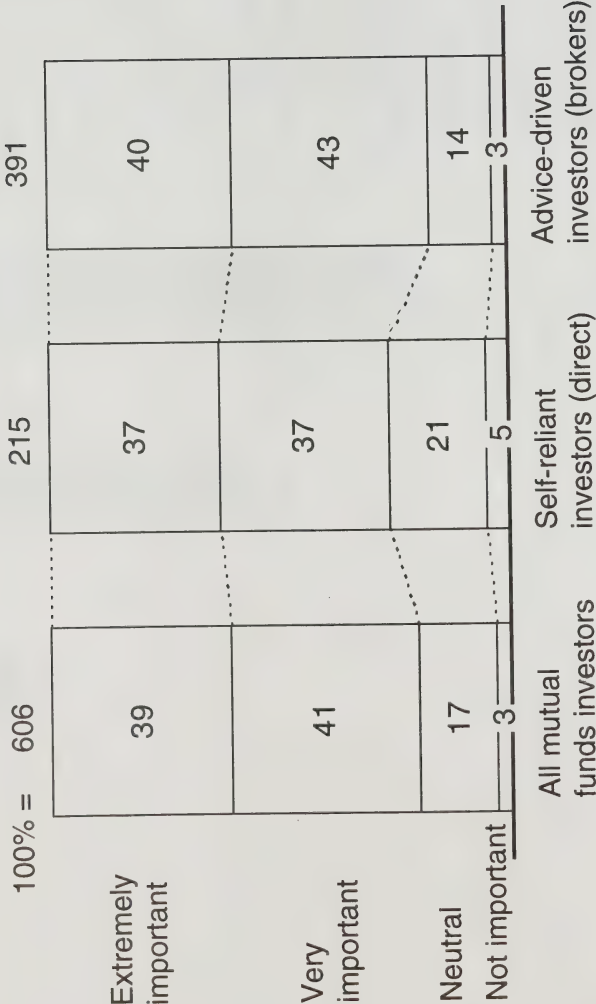
CONSUMERS ARE PLACING MORE IMPORTANCE ON BRANDS



BRAND IS IMPORTANT IN MUTUAL FUNDS

Importance of brand to consumers – mutual funds (US)

Percent of respondents



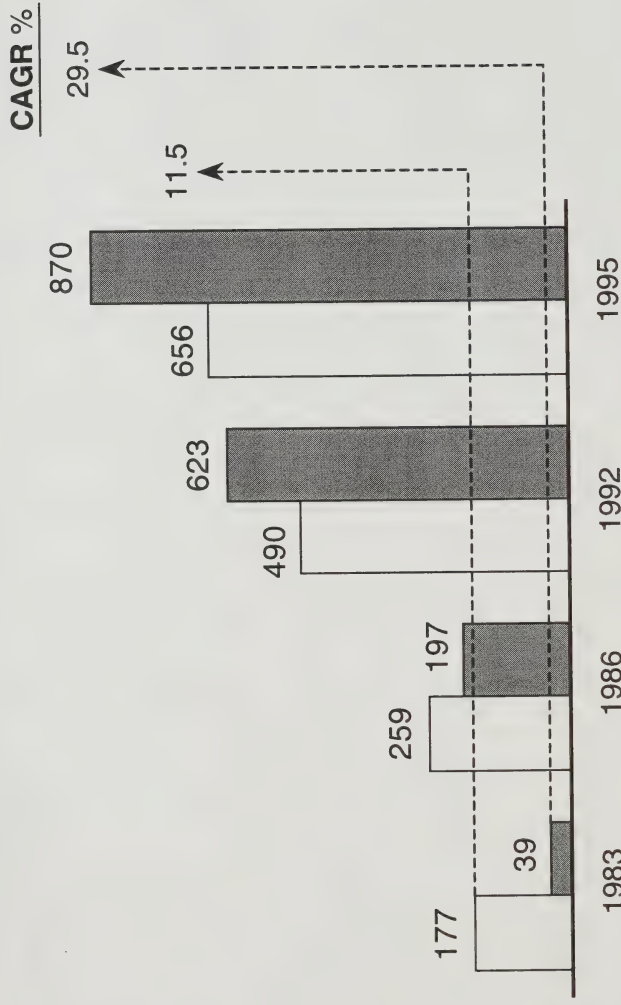
Question: How important is it for you to purchase mutual funds from a reputable, well-known mutual fund company?

CENTRAL BANKS ARE LESS EFFECTIVE AT FOREIGN EXCHANGE INTERVENTION

Exchange reserves and turnover

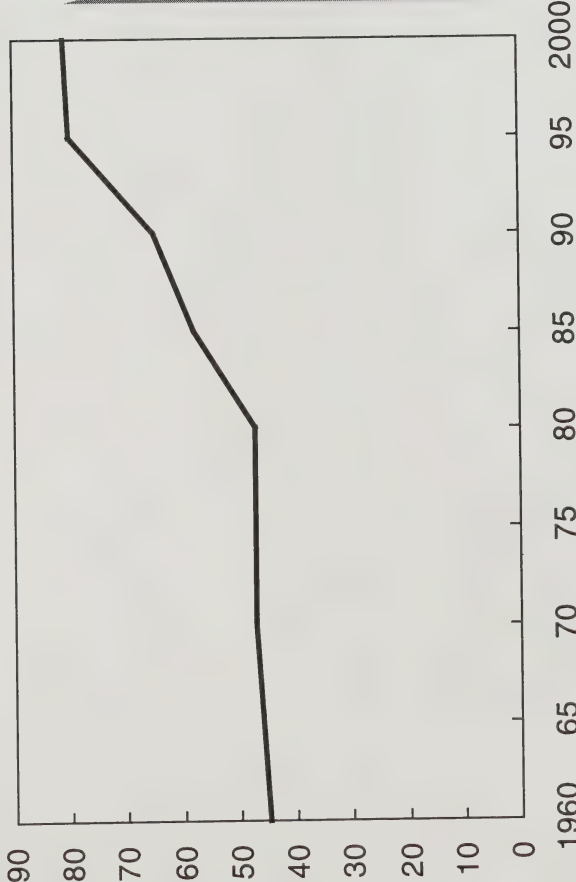
US \$ Billions

- OECD countries' foreign exchange reserves
 Average daily foreign exchange turnover in New York, London, and Tokyo



ECONOMIES ARE RAPIDLY OPENING UP

Percentage share of world GDP that are open economies



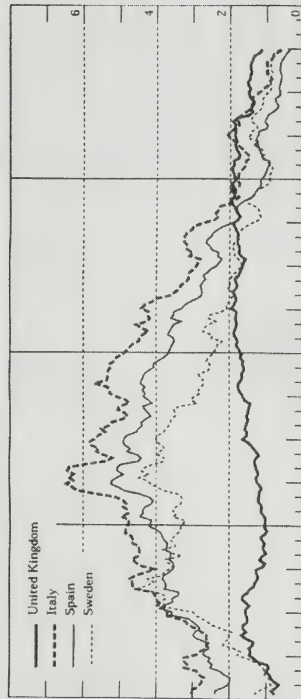
An open economy is one that has **none** of the following five characteristics

1. Non-tariff barriers covering 40% or more of products and services
2. Average tariff rates of 40% or more on products and services
3. A black market exchange rate that is depreciated by 20% or more, relative to official rate
4. A socialist economy
5. A state monopoly on major exports

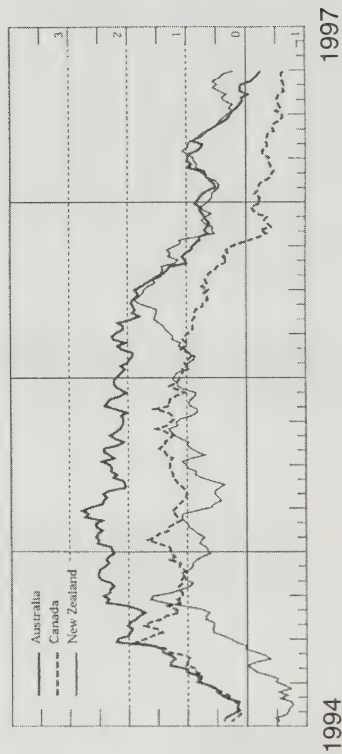
BOND PRICING CONVERGENCE IS COMMENCING

Percent

**Yield differentials
vis-à-vis long-term
German government
bonds**



**Yield differentials
vis-à-vis long-term
US government
bonds**

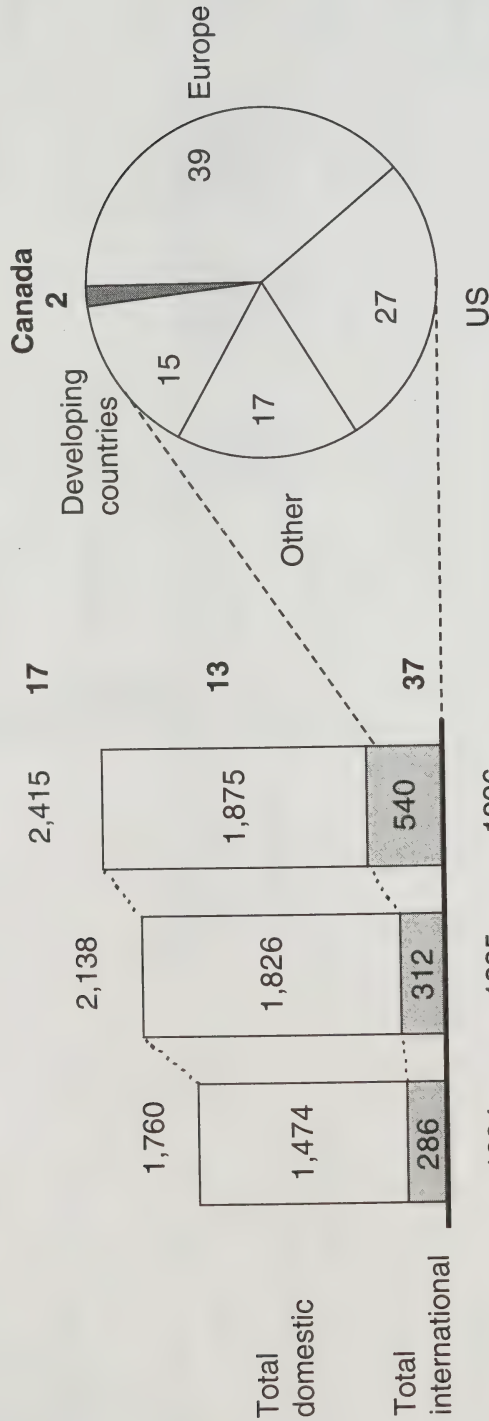


A GLOBAL BOND MARKET IS DEVELOPING

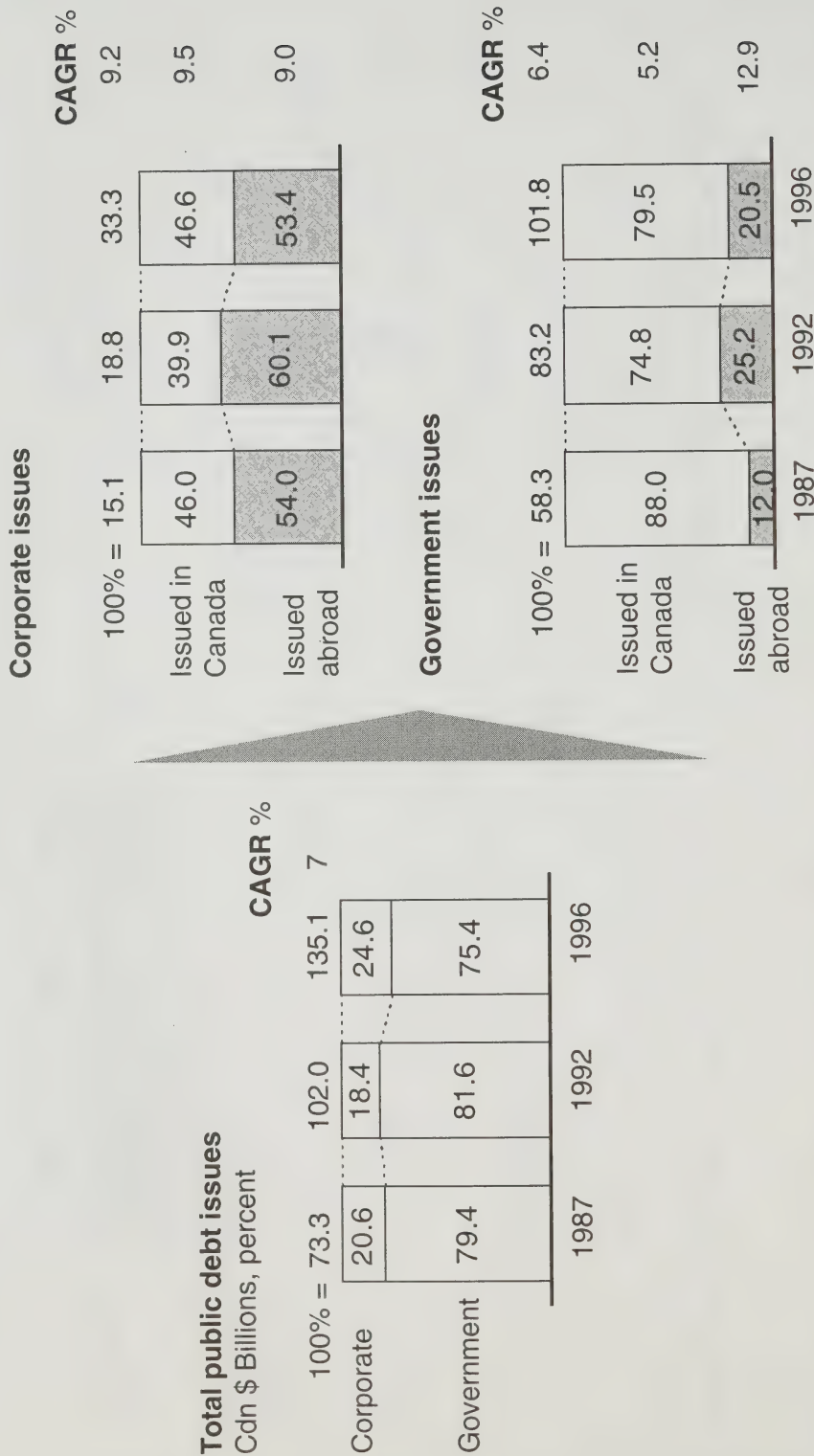
World debt securities net issues
US \$ Billions

CAGR %

100% = \$540



CANADIAN CORPORATE ISSUES ARE SKEWED TO THE INTERNATIONAL MARKET

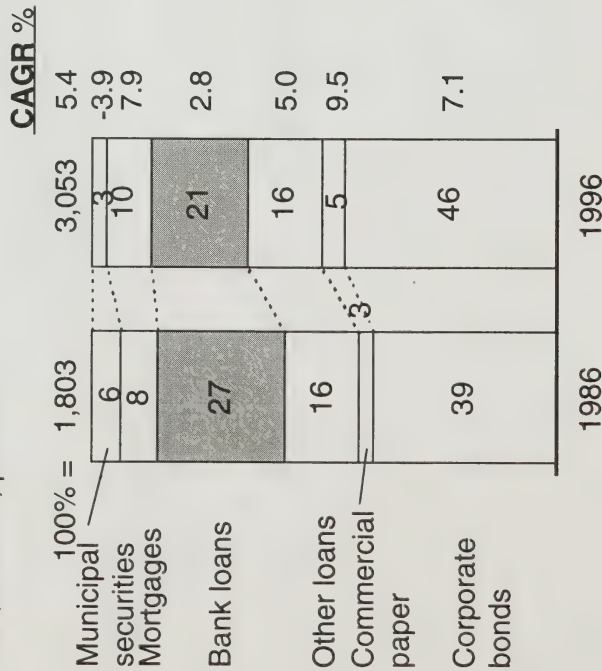


Chapter 4 Exhibits

TRADITIONAL BANK FINANCING IS DECLINING AS A SHARE OF ALL CORPORATE DEBT

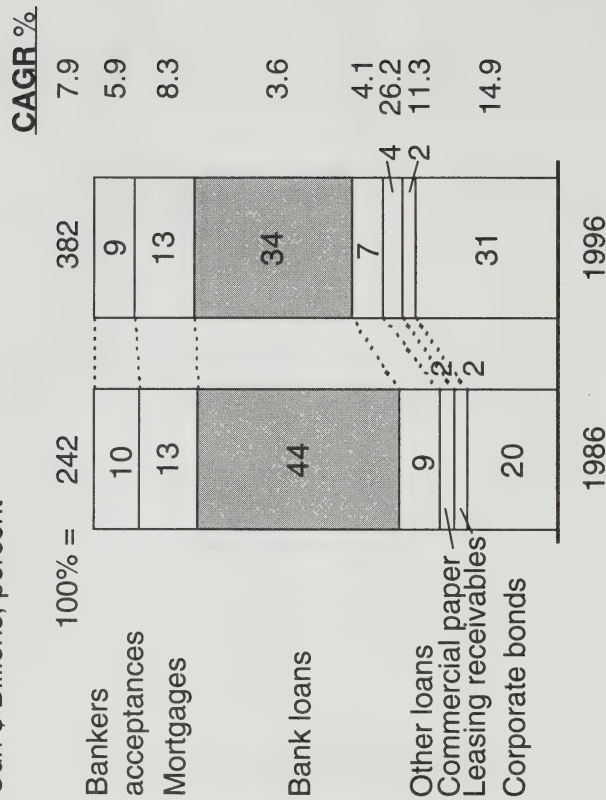
US corporate debt*

US \$ Billions, percent



Canada corporate debt

Cdn \$ Billions, percent




* Of non-farm, non-financial institutions

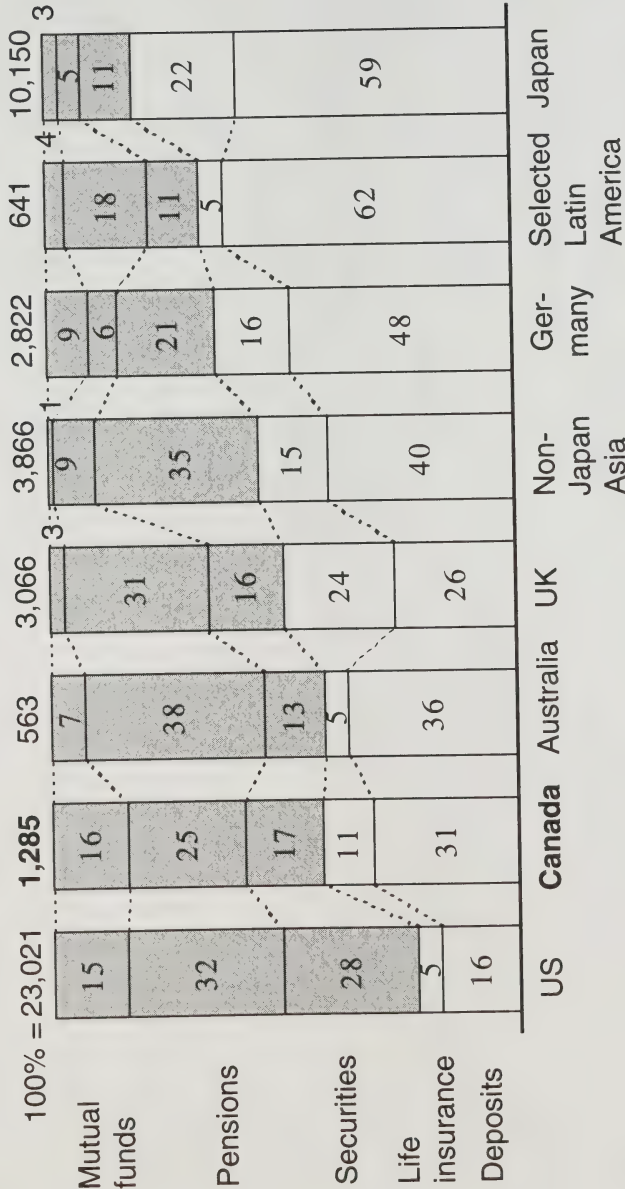
Source: US Federal Reserve Flow of Funds; Bank of Canada; McKinsey & Company analysis

**MAJORITY OF CANADIANS INVEST PERSONAL FINANCIAL ASSETS DIRECTLY
IN CAPITAL MARKETS**

US \$ Billions, percent, 1997

ESTIMATES

 Invested directly in capital markets



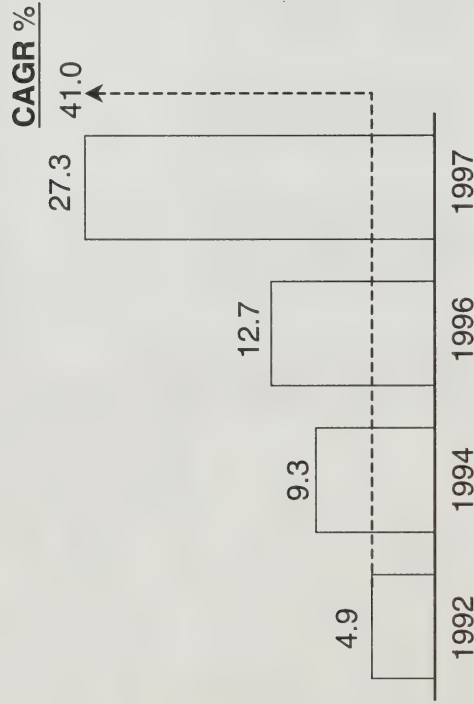
Note: Asset percentages vary from Exhibit 3-9 due to dispersion of "other" category to general PFS categories

Source: McKinsey & Company Global PFS Model

CANADIAN SECURITIZATION IS GROWING RAPIDLY

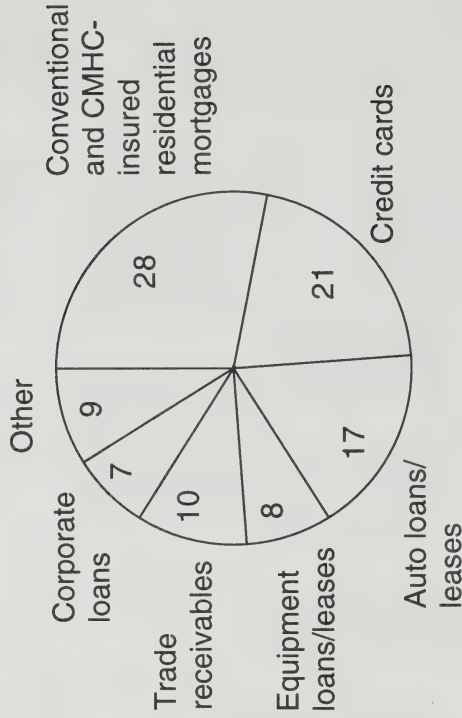
ESTIMATE

Outstanding asset-backed securities
Cdn \$ Billions

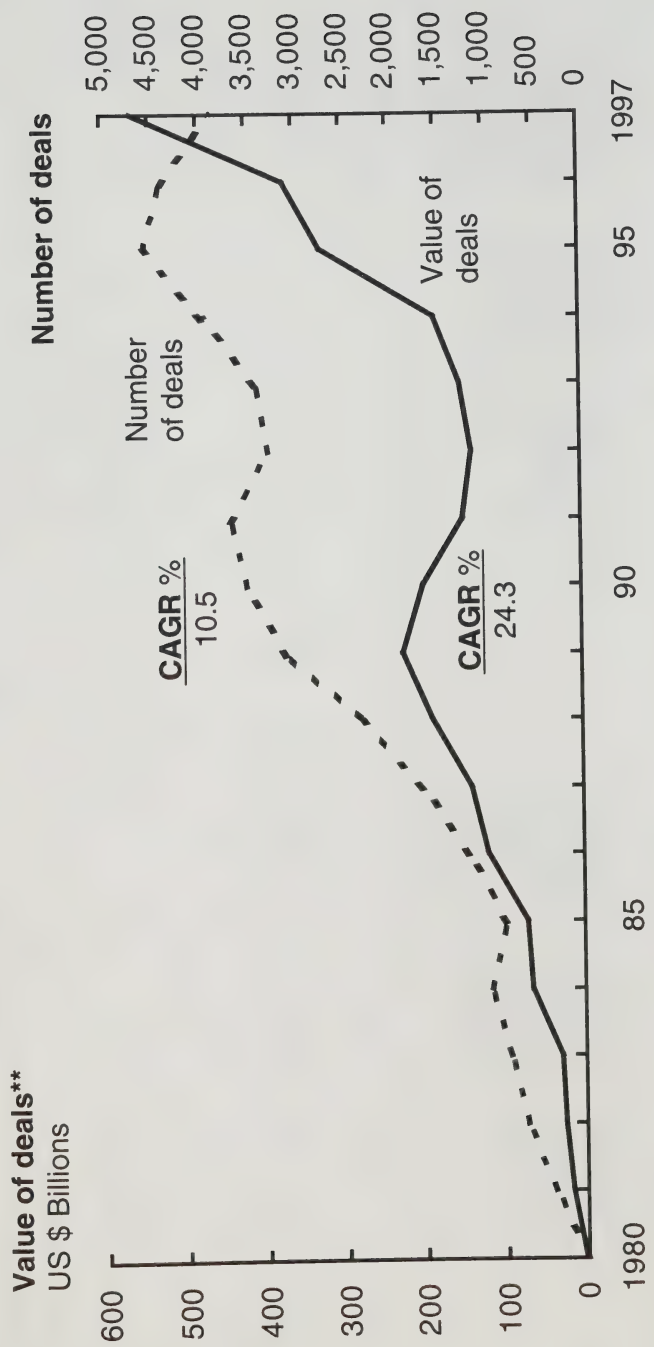


Composition of securitized asset-backed securities
Cdn \$ Billions, percent

100% = \$27.3



WORLDWIDE FINANCIAL INDUSTRY MERGERS AND ACQUISITIONS* ARE ACCELERATING



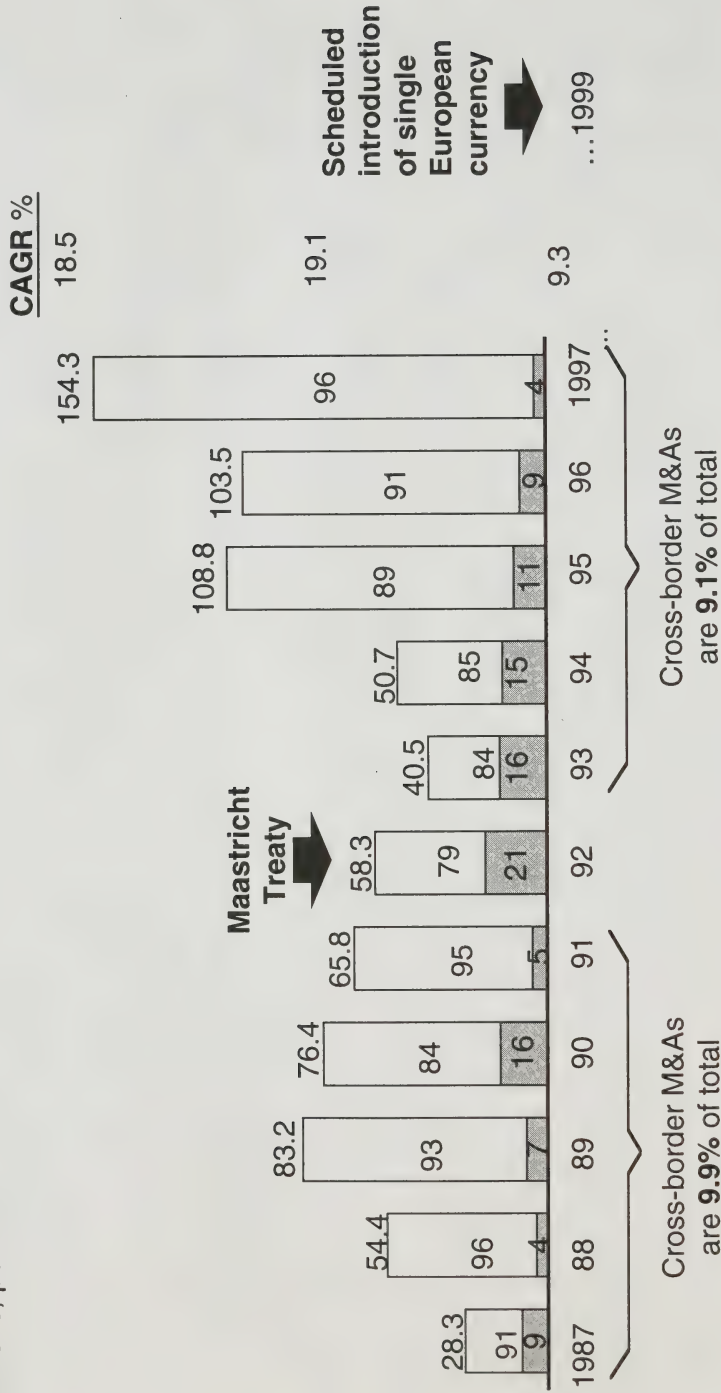
* Includes all executed and completed transactions

** Financial institutions include commercial banks, savings institutions, credit unions, non-domestic banks and branches, personal and business credit institutions, mortgage brokers, security dealers and brokers, life insurance companies, bank holding companies

EUROPEAN FINANCIAL INSTITUTIONS** MERGERS AND ACQUISITIONS** ARE INCREASING

US \$ Billions, percent

Domestic transactions
Cross-border transactions



* Includes commercial banks, savings institutions, credit unions, non-domestic banks and branches, personal and business credit institutions, mortgage bankers, security dealers and brokers, life insurance companies, bank holding companies

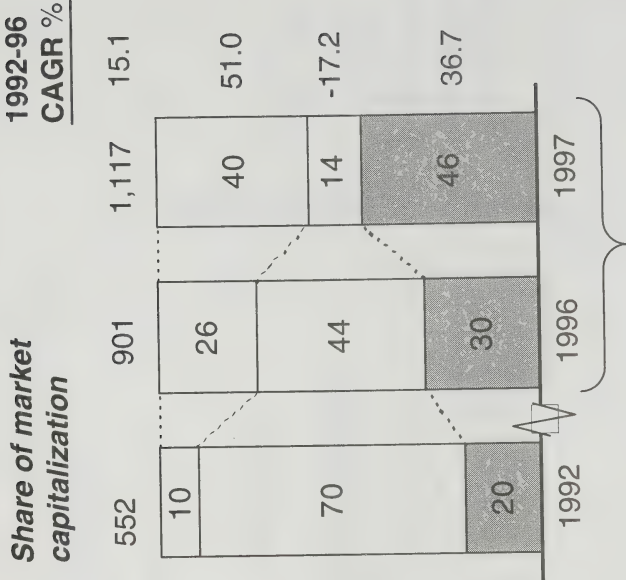
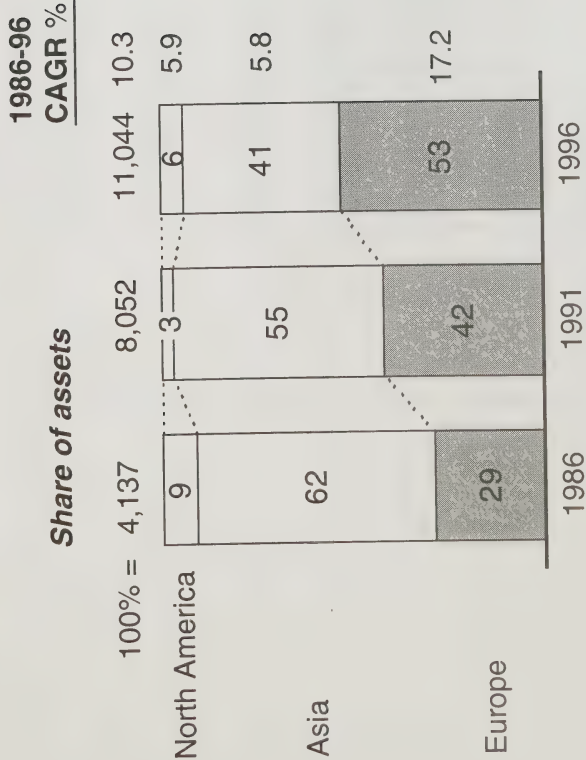
** Includes all executed and completed transactions

Source: Securities Data Company; McKinsey & Company analysis

TOP GLOBAL BANKS ARE PREDOMINANTLY EUROPEAN

Top 30 global banks by region of origin

US \$ Billions, percent

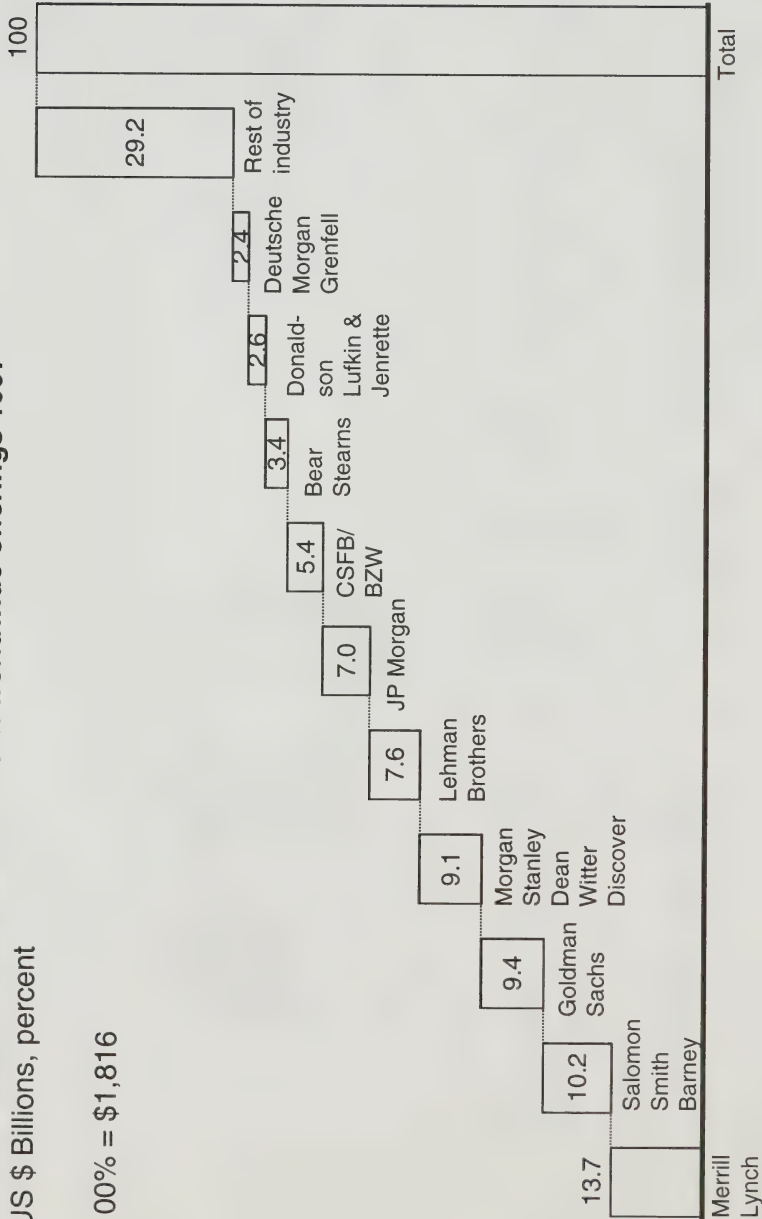


INVESTMENT BANKS ARE CONCENTRATED GLOBALLY

Market share of investment banks in worldwide offerings 1997

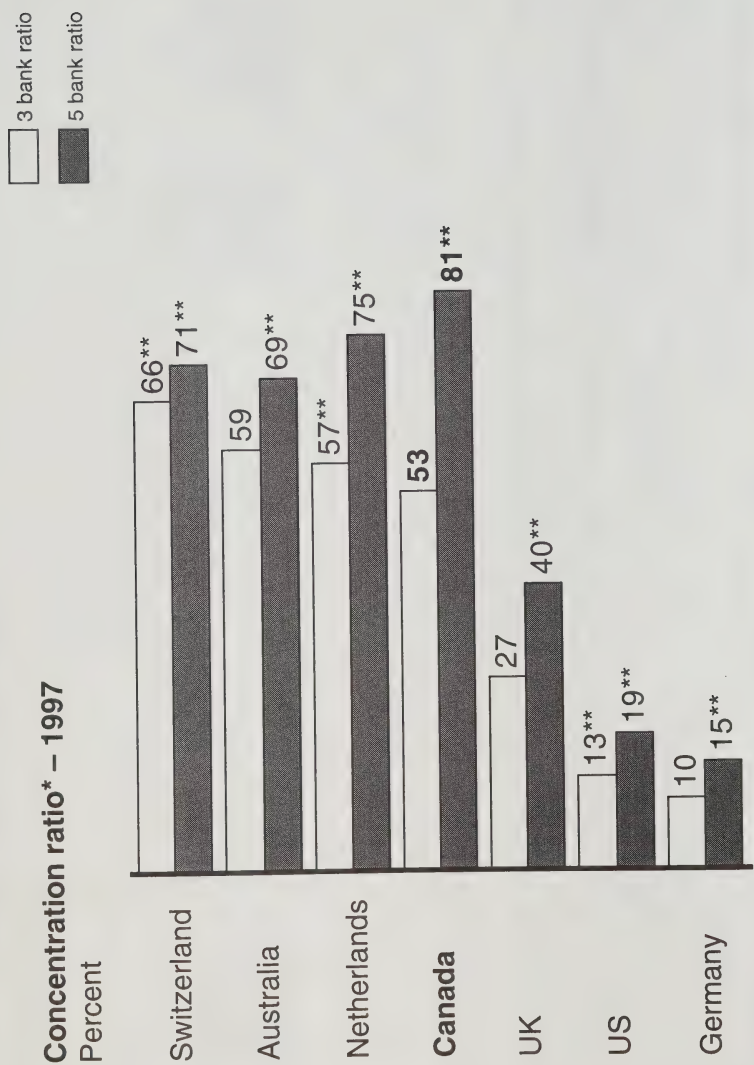
US \$ Billions, percent

100% = \$1,816



The Top 10 investment banks have 71% of the worldwide securities markets

CANADA HAS A RELATIVELY CONCENTRATED MARKET



* Percentage of domestic banking assets controlled by Top 3 and Top 5 banks (by assets) in the country as of December 1997

** 1996 figures

Source: Reserve Bank of Australia Bulletin; Deutsche Bundesbank Monthly Report; annual reports; ONS financial statistics; Bank of Canada; McKinsey & Company analysis

CONCENTRATION DECREASES SUBSTANTIALLY WHEN ALL FINANCIAL ASSETS ARE CONSIDERED

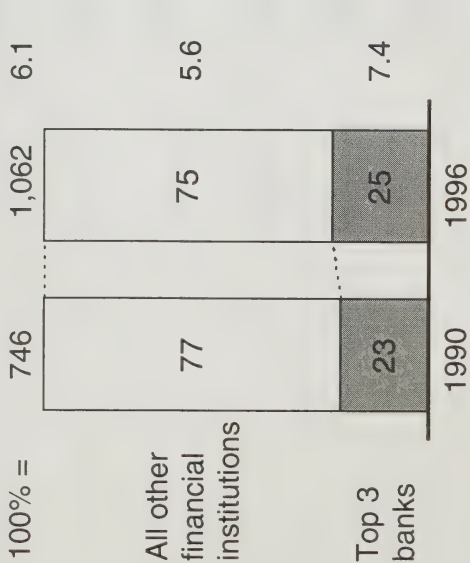
■ Top 3 banks

Total financial assets

Australia

A \$ Billions, percent*

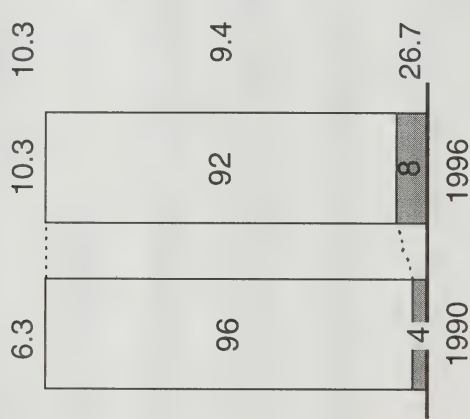
CAGR %



United States

US \$ Trillions, percent**

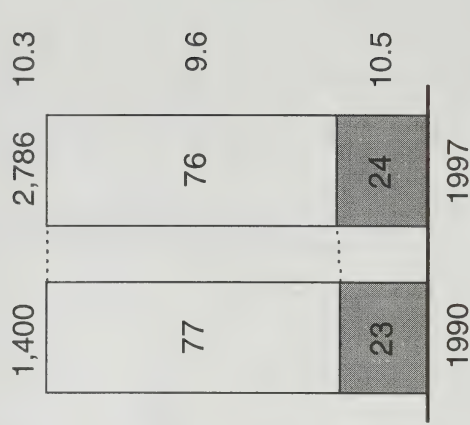
CAGR %



Canada

Cdn \$ Billions, percent

CAGR %

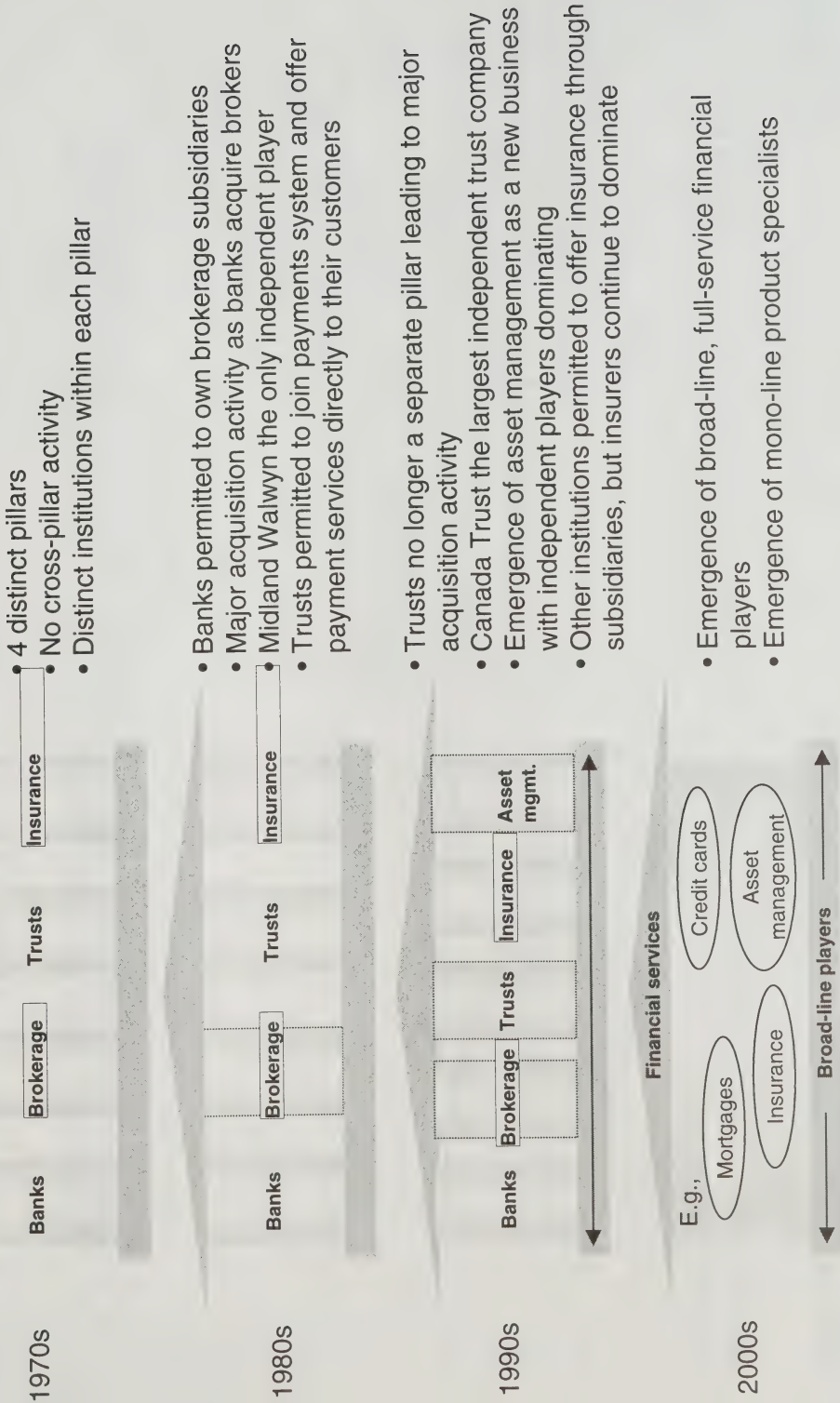


* Includes banks, non-bank financial institutions, life offices, superannuation funds, other managed funds

** Includes banks, insurance, and mutual funds

Source: Federal Reserve; annual reports; *The Banker*; McKinsey & Company analysis

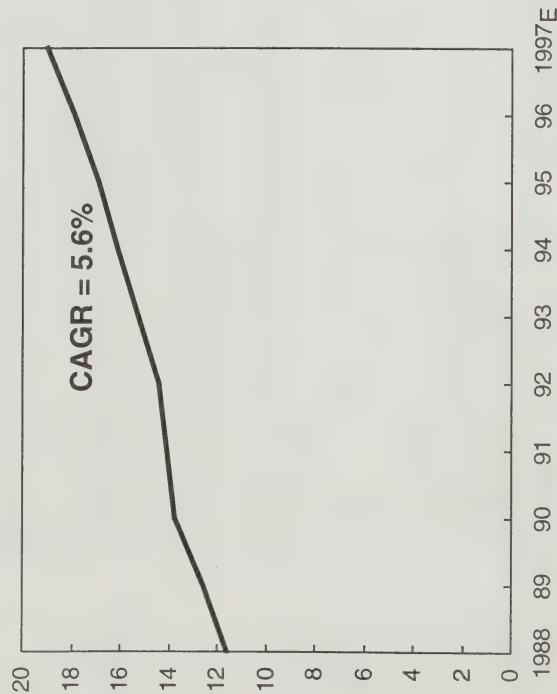
CANADA'S TRADITIONAL FOUR-PILLAR SYSTEM HAS CHANGED



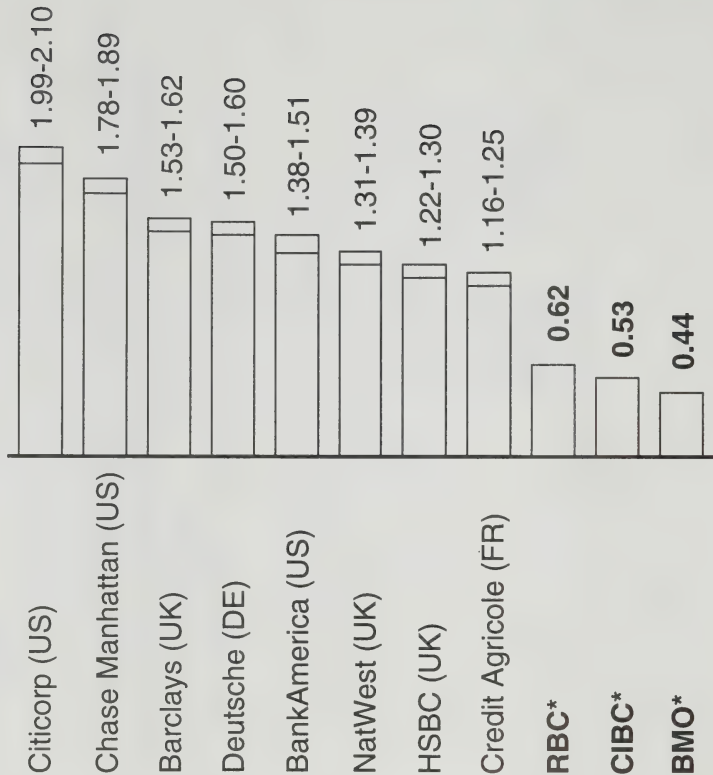
TOP BANK IT SPENDING CONTINUES

ESTIMATE

US commercial bank IT spending
US \$ Billions



Estimated IT spending for several banks 1997
US \$ Billions

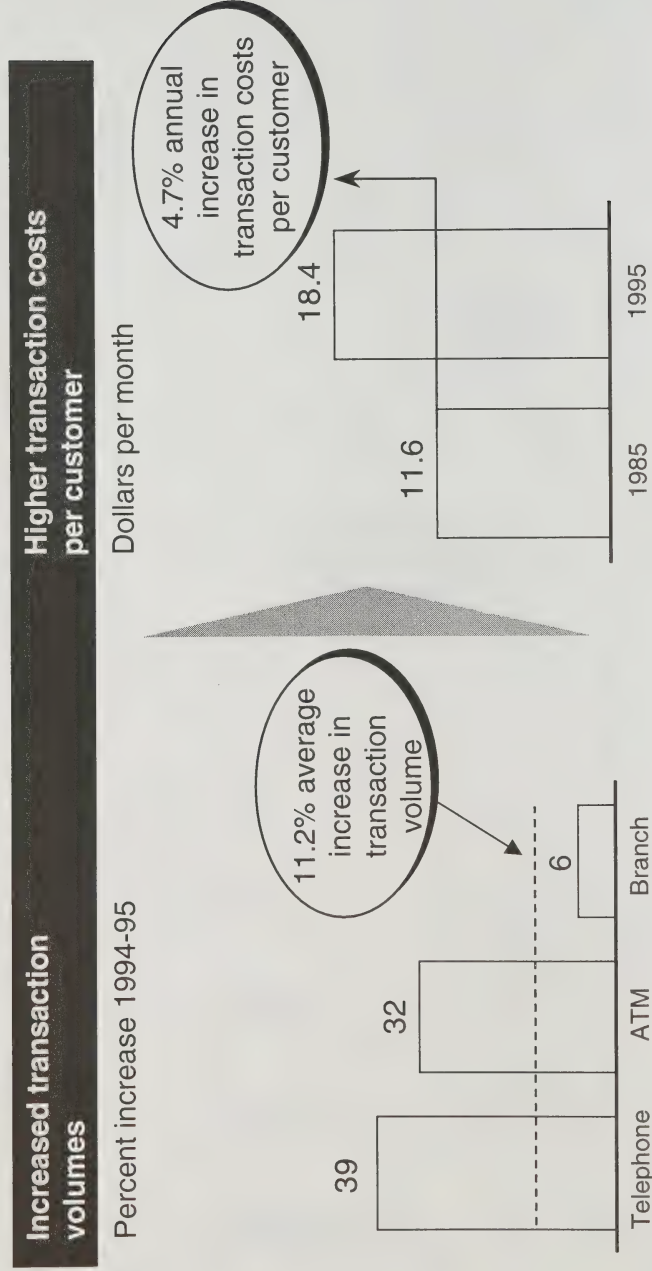


* 1996

Source: The Tower Group; Mitchell Madison Group; The Banker, The Globe and Mail

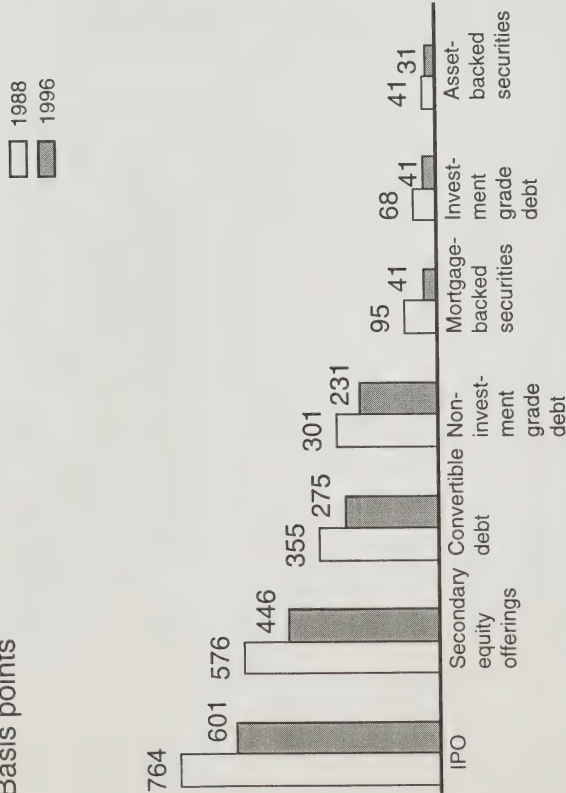
MULTIPLE CHANNELS HAVE SIGNIFICANTLY INCREASED CUSTOMER TRANSACTION COSTS

US EXPERIENCE



PROFITABILITY OF US INVESTMENT BANKS IS DECLINING

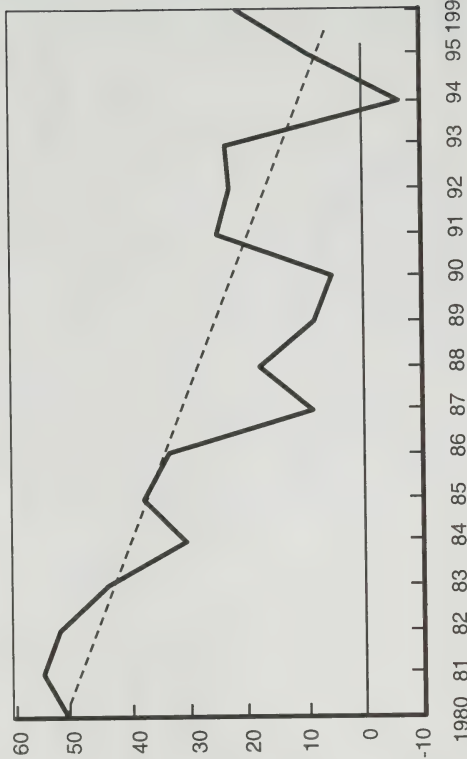
Average US gross spreads 1988-96
Basis points



Total percentage change

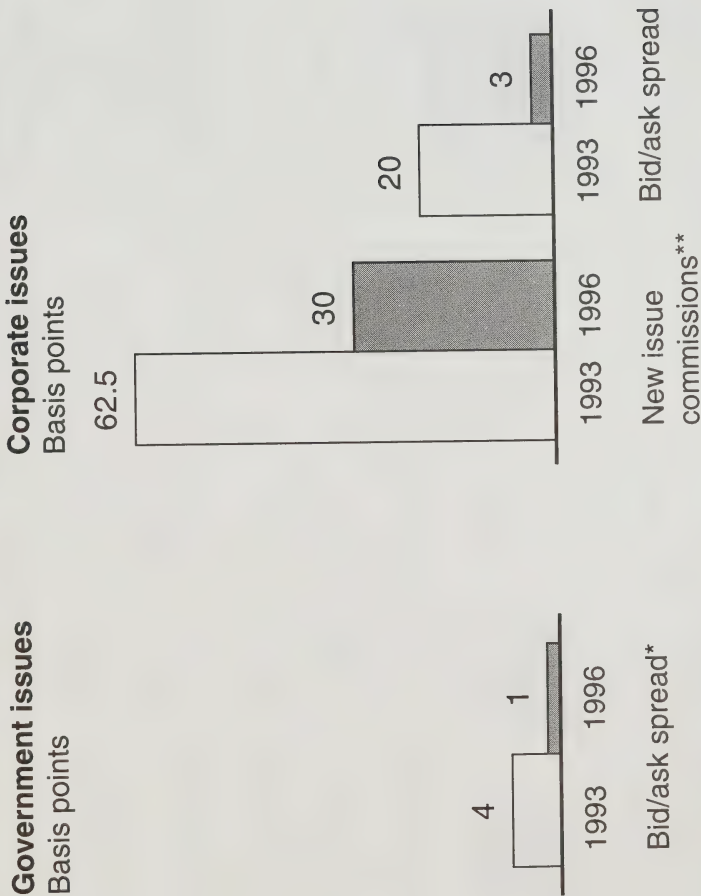
-21	-23	-23	-57	-40	-24
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Pretax ROE of large investment banks*
Percent



* Including Bear Stearns, Dillon, First Boston, Goldman Sachs, Lazard, Morgan Stanley Dean Witter/Discover, Salomon, Westheim
Source: McKinsey & Company Global FIG Practice; Securities Industry Association database; IDD

DOMESTIC CANADIAN FIXED-INCOME MARGINS HAVE DECLINED

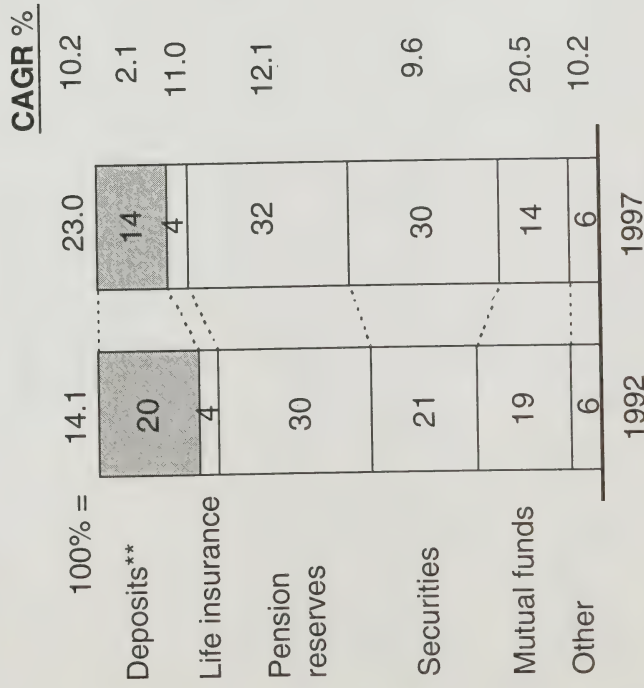


* Estimated average of provincial and federal bonds
** Mainly due to the increasing use of MTNS (medium-term notes)
Source: Bloomberg

CANADIAN HOUSEHOLDS ARE SHIFTING ASSET PORTFOLIOS

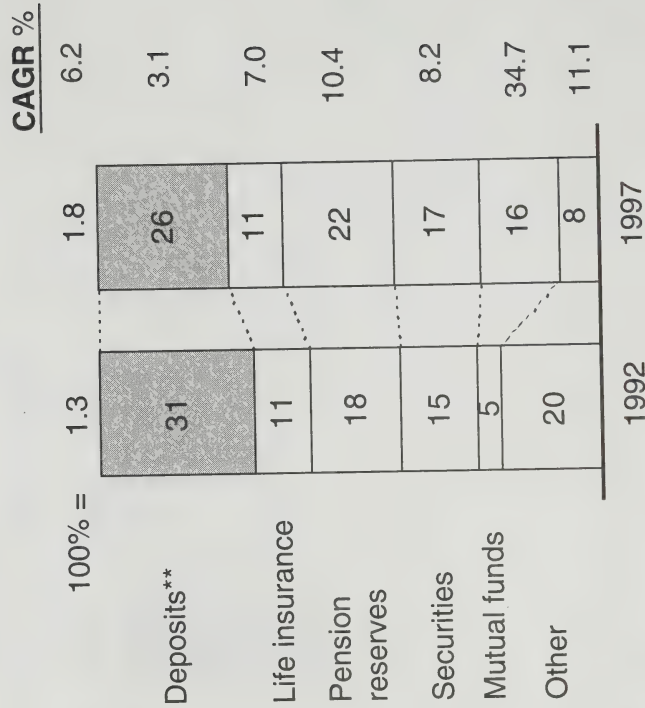
US household financial assets*

US \$ Trillions



Canada household financial assets

Cdn \$ Trillions



* Includes households and non-profit organizations

** Includes savings, chequing, foreign currency/deposits

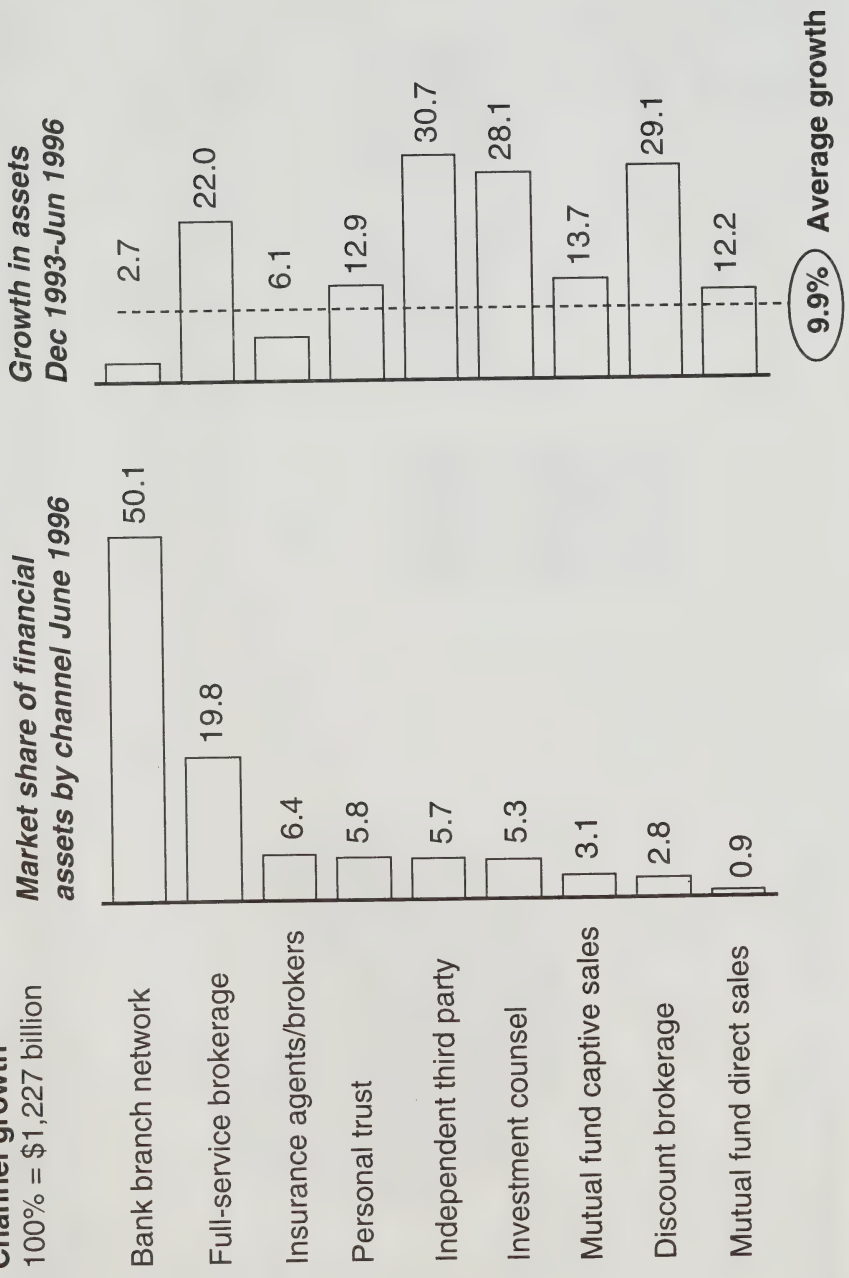
Source: US Federal Reserve Funds Flow; Bank of Canada Review; Ernst & Young report; McKinsey & Company analysis

TRADITIONAL CHANNELS ARE GROWING MORE SLOWLY

CANADIAN EXAMPLE

Channel growth

100% = \$1,227 billion

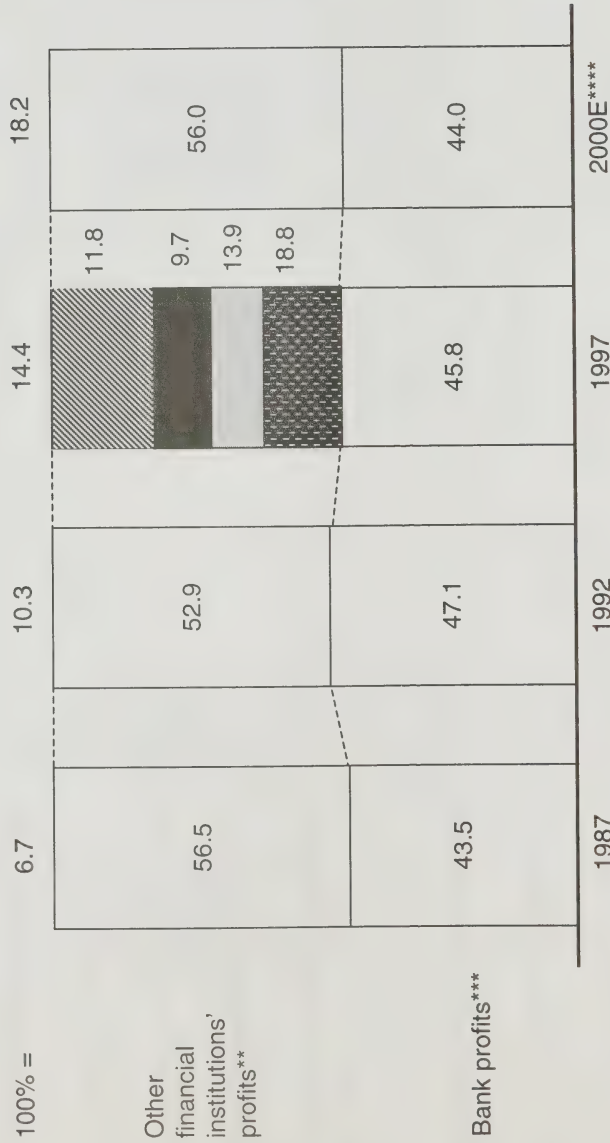


BANKS CONTROL LESS THAN HALF OF CANADIAN PFS AND LIFE INSURANCE PROFITS

ESTIMATES

Total pretax PFS* and insurance benefits

Cdn \$ Billions, percent



* Includes before-tax profits in mortgages, consumer loans, deposits, mutual funds, securities, and life insurance

** Other includes trusts, finance companies, life insurance companies; credit unions, mutual fund managers, pension managers

*** Chartered banks

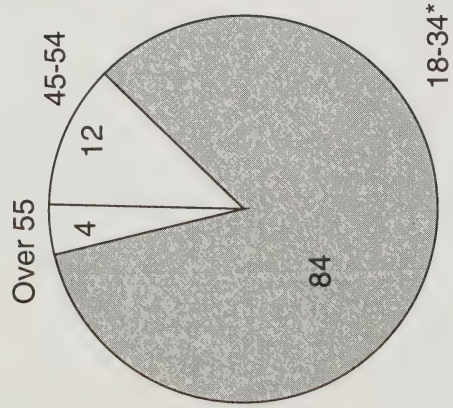
**** Assumes no major insurance acquisitions by the banks

Source: Bank of Canada; IFIC; McKinsey & Company PFS Model; OSFI

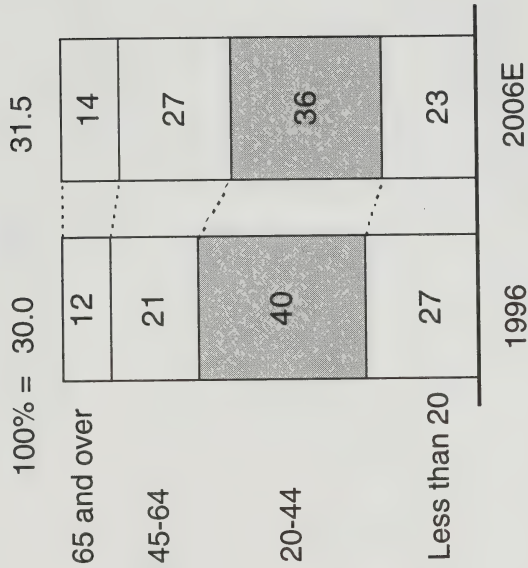
DEMOGRAPHIC TRENDS ARE AFFECTING DEMAND FOR TRADITIONAL LIFE INSURANCE

Prime life insurance
buying years

Age distribution of new buyers of ordinary life
Percent of policies (based on amount)

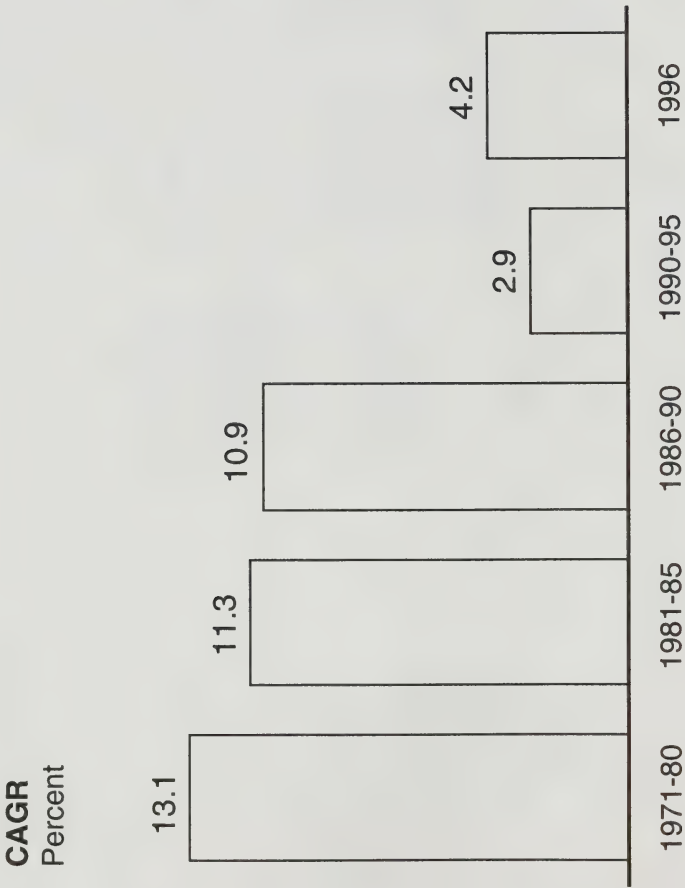


Age distribution of Canadian population
Millions



* Includes purchases made prior to age 18
Source: Canadian Life and Health Insurance Facts; McKinsey & Company analysis

GROWTH IN CANADIAN LIFE AND ANNUITIES PREMIUMS HAS DECLINED

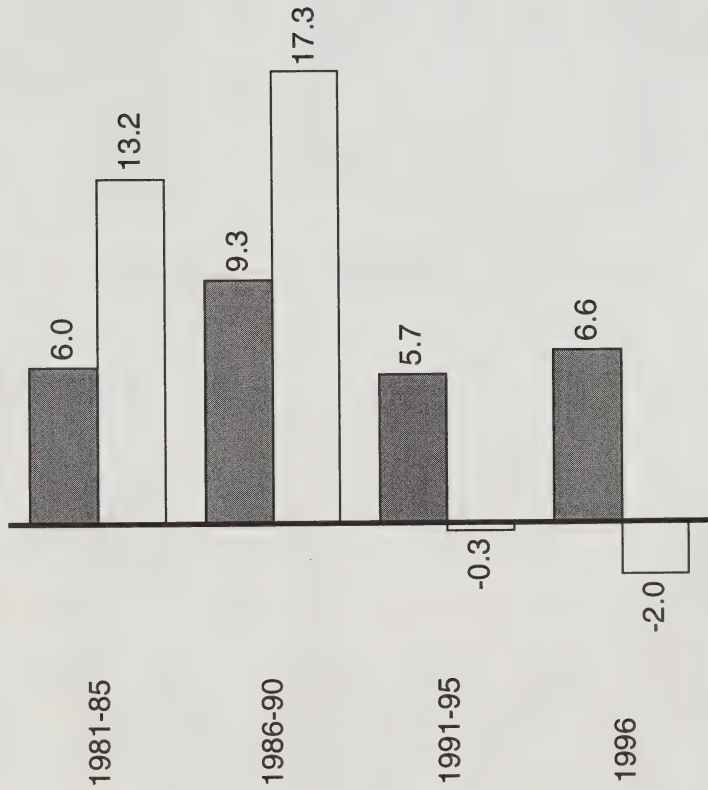


GROWTH IN INDIVIDUAL LIFE HAS RECENTLY OUTPACED ANNUITIES PREMIUMS

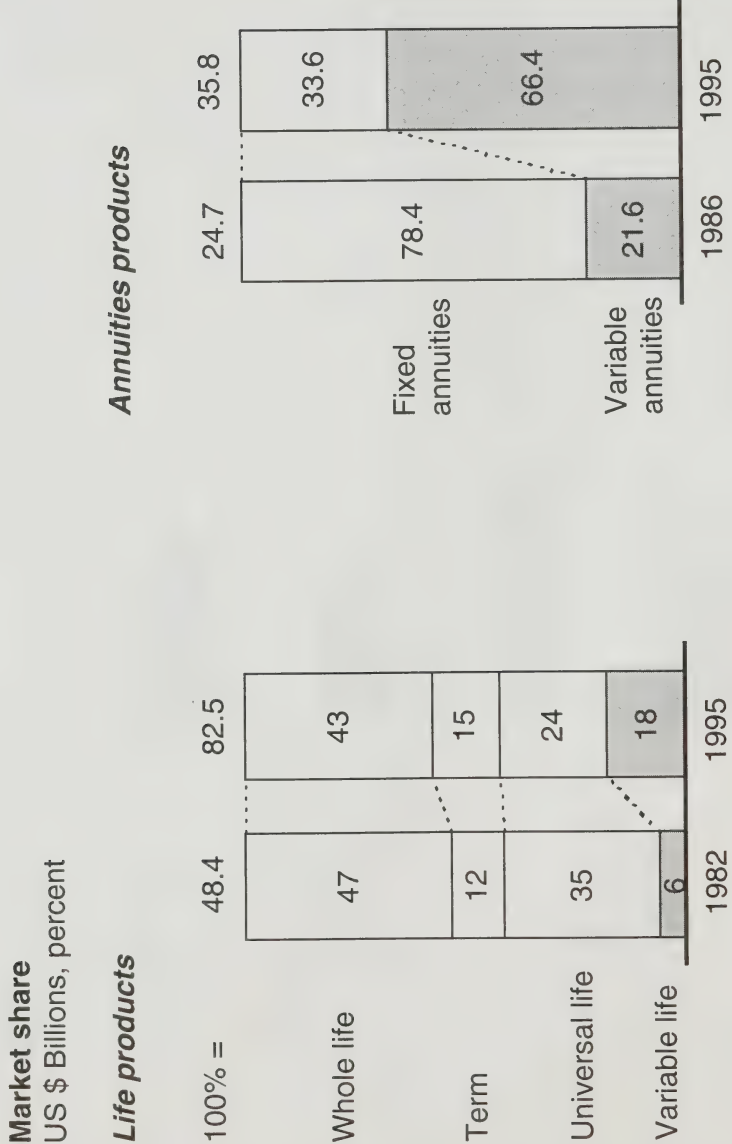
CANADIAN EXAMPLE

**Premiums
CAGR percent**

■ Life insurance
□ Annuities



PRODUCT MIX IS SHIFTING US EXAMPLE



Source: LIMRA; ACLI; VARDS; Best's Aggregates and Averages

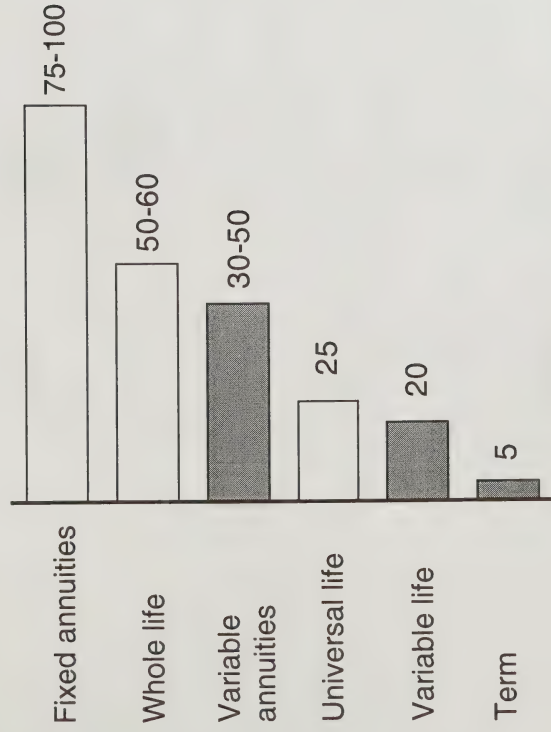
HIGHER GROWTH PRODUCTS HAVE LOWER MARGINS

US ESTIMATE

■ Increasing share of product sales

Spreads

Basis points



Intermediated

Returns on fixed annuities and whole life products are driven by fixed income spreads and, therefore, provide consistent and relatively high returns

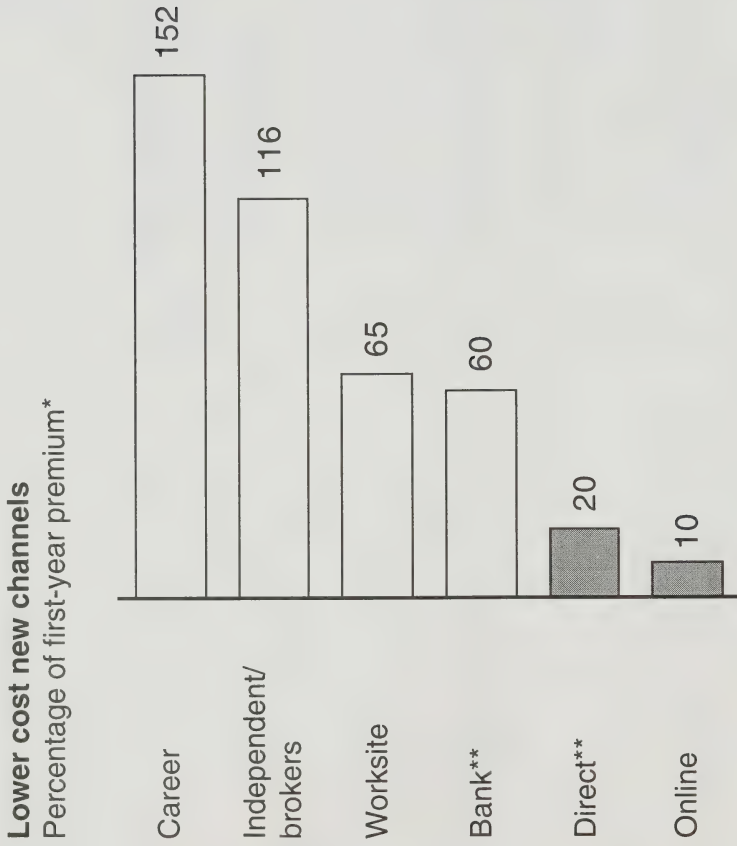
Disintermediated

Margins of variable life and annuity products are tied to capital market investments and, as a result, tend to track market indices

Low value added

Margins on term products are slim as there is little value in the underwriting of basic mortality risk

NEW DISTRIBUTION CHANNELS ARE MUCH LOWER COST



* Ordinary life acquisition cost

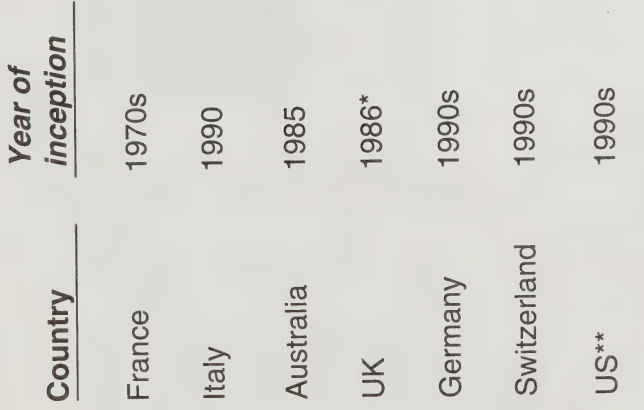
** UK experience

Source: McKinsey & Company analysis

BANCASSURANCE HAS PROVED VIABLE IN OTHER COUNTRIES

Bank market share of life insurance premiums 1996

Percent



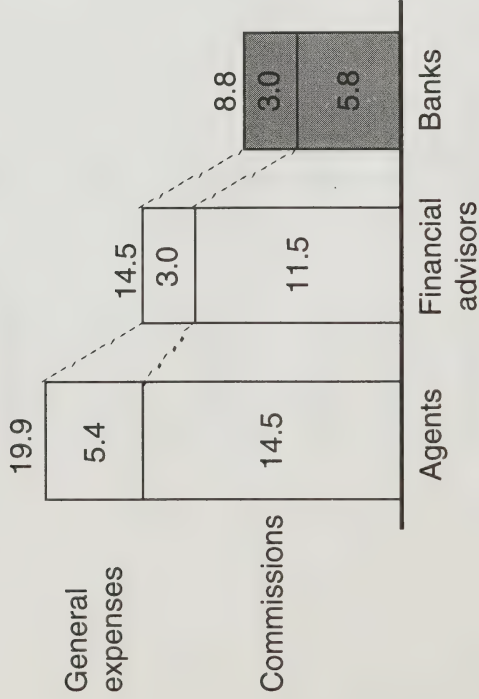
* Financial Services Act bancassurance has existed since the late 1960s

** 1997 data

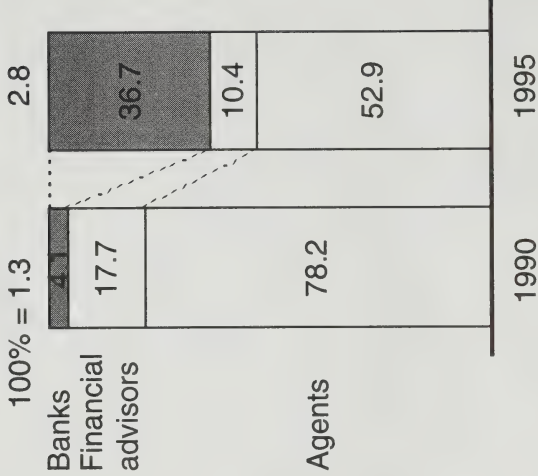
Source: Datamonitor; L/H Review US 98; Insurance & Superannuation Commission Life Insurance Group Australia; McKinsey & Company analysis

BANCA ASSURANCE IN ITALY HAS SUCCEEDED BECAUSE OF A COST ADVANTAGE

Cost ratios by channel 1995
Cdn \$ Billions



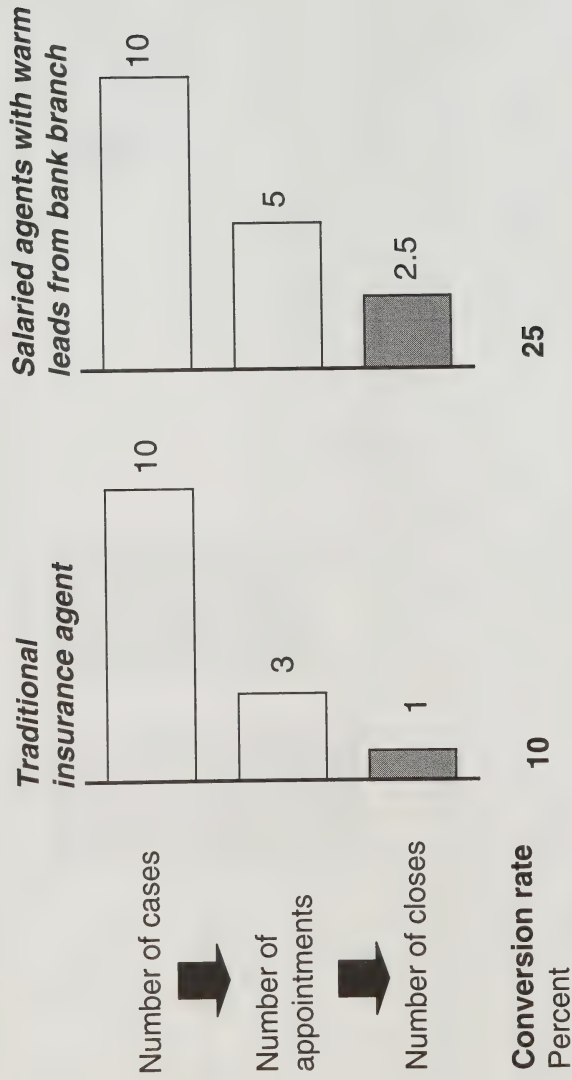
New life business*
Cdn \$ Billions, percent



* First-year premiums + increases of single premium for banks; first-year premiums + 1/10 of single premium for other channels
Source: ANIA; Isvap; Il Giornale delle Assicurazioni; McKinsey analysis

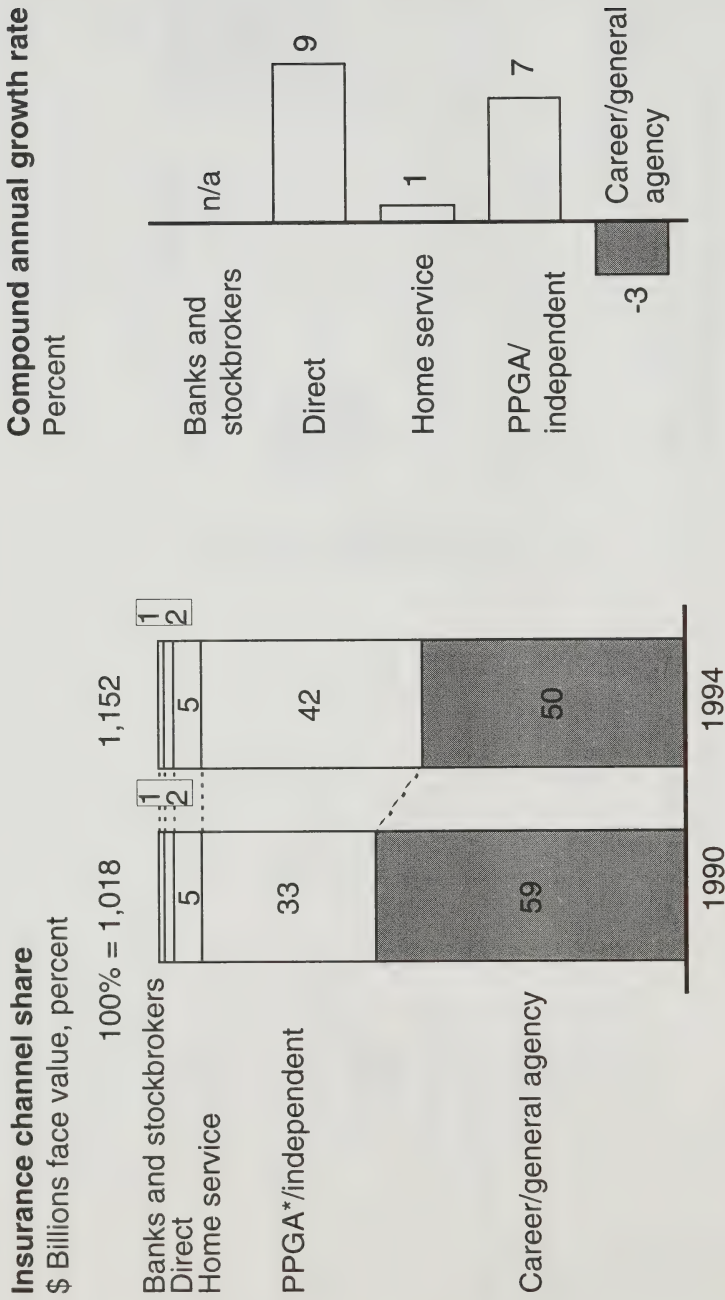
BANKS HAVE HIGHER PRODUCTIVITY THAN TRADITIONAL AGENTS

Average sales performance



CAREER AGENTS ARE LOSING SHARE TO OTHER PROVIDERS

US EXAMPLE

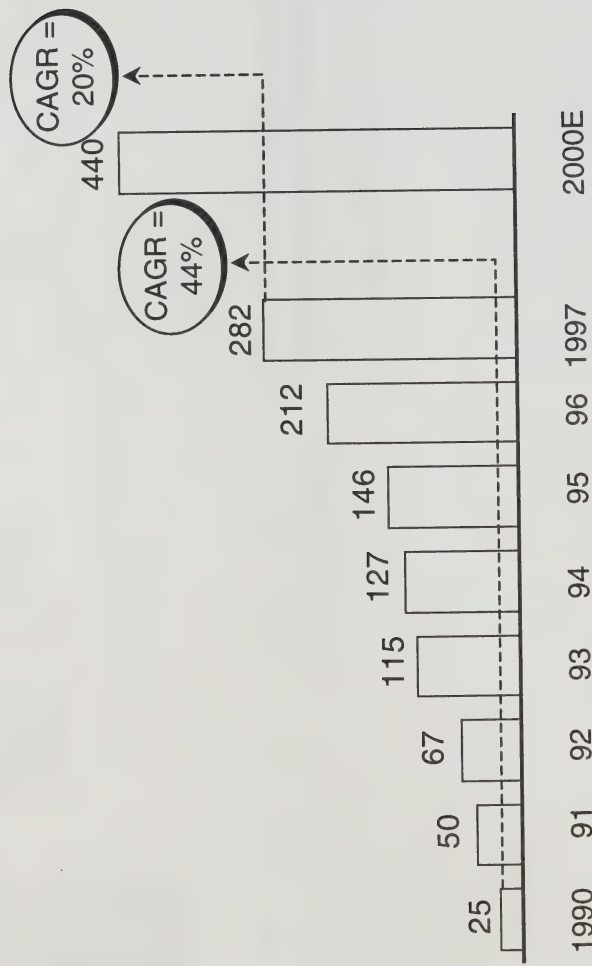


* Primary-producing general agent
Source: Conning and Company; McKinsey & Company analysis

MUTUAL FUND* GROWTH IN CANADA HAS BEEN STRONG

CANADIAN EXAMPLE

Assets under management
Cdn \$ Billions



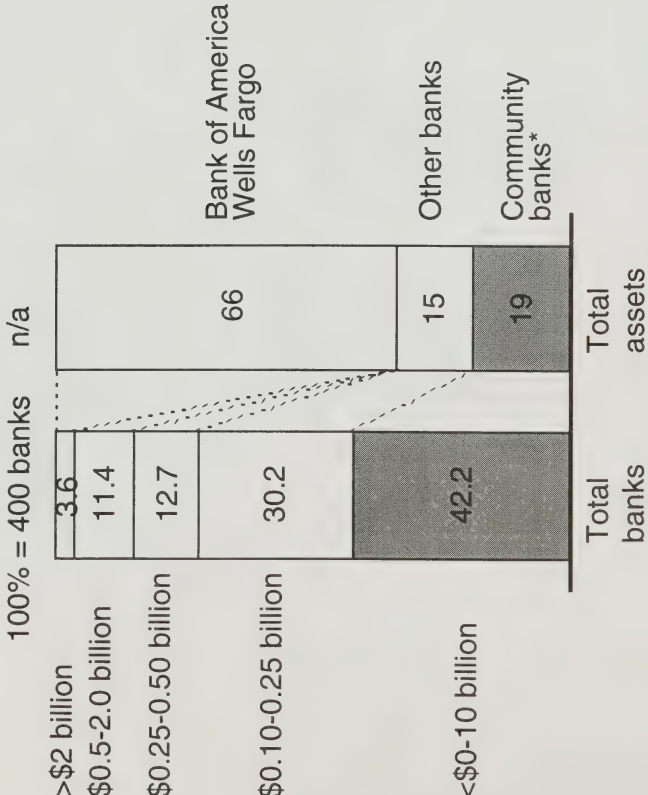
* Including money markets
Source: IFIC; McKinsey & Company analysis

COMMUNITY BANKS ARE EMERGING TO FILL SERVICE GAPS

US EXAMPLE

California banking by size of bank (assets)

Percent, 1997



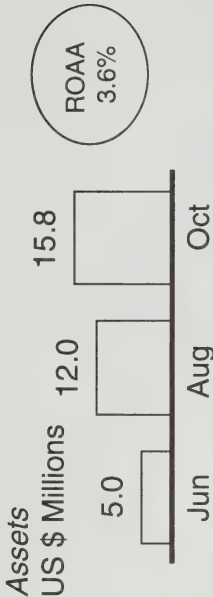
Disgruntled customers...

“There is a sense of being angry [after large bank mergers], a sense of loss of community, which is propelling our growth”

D. Fischer, owner, community bank

...are driving growth of new community banks

Ranchero Community Bank
(opened June 1997 with 16 employees)



Vision: “A supermarket of exceptional banking services, not a bank in a supermarket”

* Independent (not owned by a large bank holding company), focus on particular community, and have <\$500 million in assets
Source: California Bankers Association; literature search

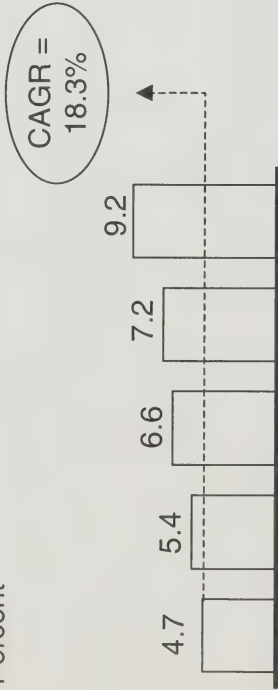
Chapter 5 Exhibits

CANADA'S FINANCIAL SECTOR IS IMPORTANT TO THE CANADIAN ECONOMY

Finance and insurance share of

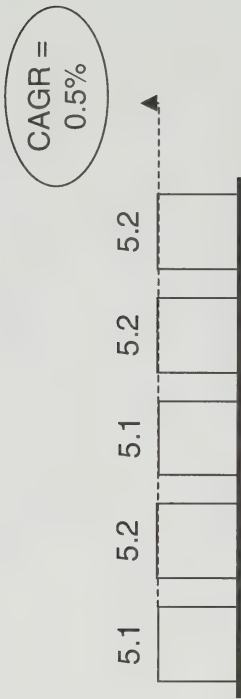
Private and public capital expenditure

Percent



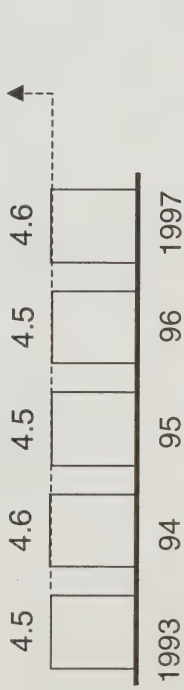
Gross domestic product

Percent



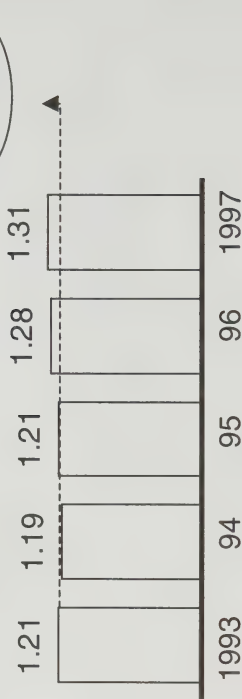
Employment

Percent



Average weekly earnings

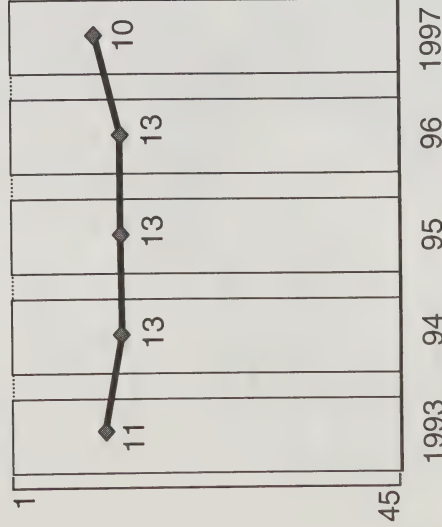
Multiple of all industries



IMD* RANKS CANADA'S FINANCE SECTOR AS STRONG AND IMPROVING

Overall finance ranking

Out of 45



Overall finance ranking		Overall finance ranking	
Out of 45		Out of 45	
Component (select)		Rank	
		Out of 45	
Banking sector efficiency	• Central bank policy	4	
	• Interest rate spreads	4	
	• Adequate legal regulation	7	
	• Size of banks	11	
Availability of capital	• Venture capital	2	
	• Stock markets	8	
	• Access to foreign capital markets	18	
	• Credit	14	
	• Access to local capital markets	16	
Cost of capital	• Factoring	18	
	• Cost of capital	6	
	• Country credit rating**	14	
	• Real, short-term interest rates (1996)	17	
Stock market dynamism	• Insider trading rules	5	
	• Stock market capitalization	6	
	• Listed domestic companies	6	
	• Rights of shareholders	7	
	• Value traded	11	

* International Institute for Management Development

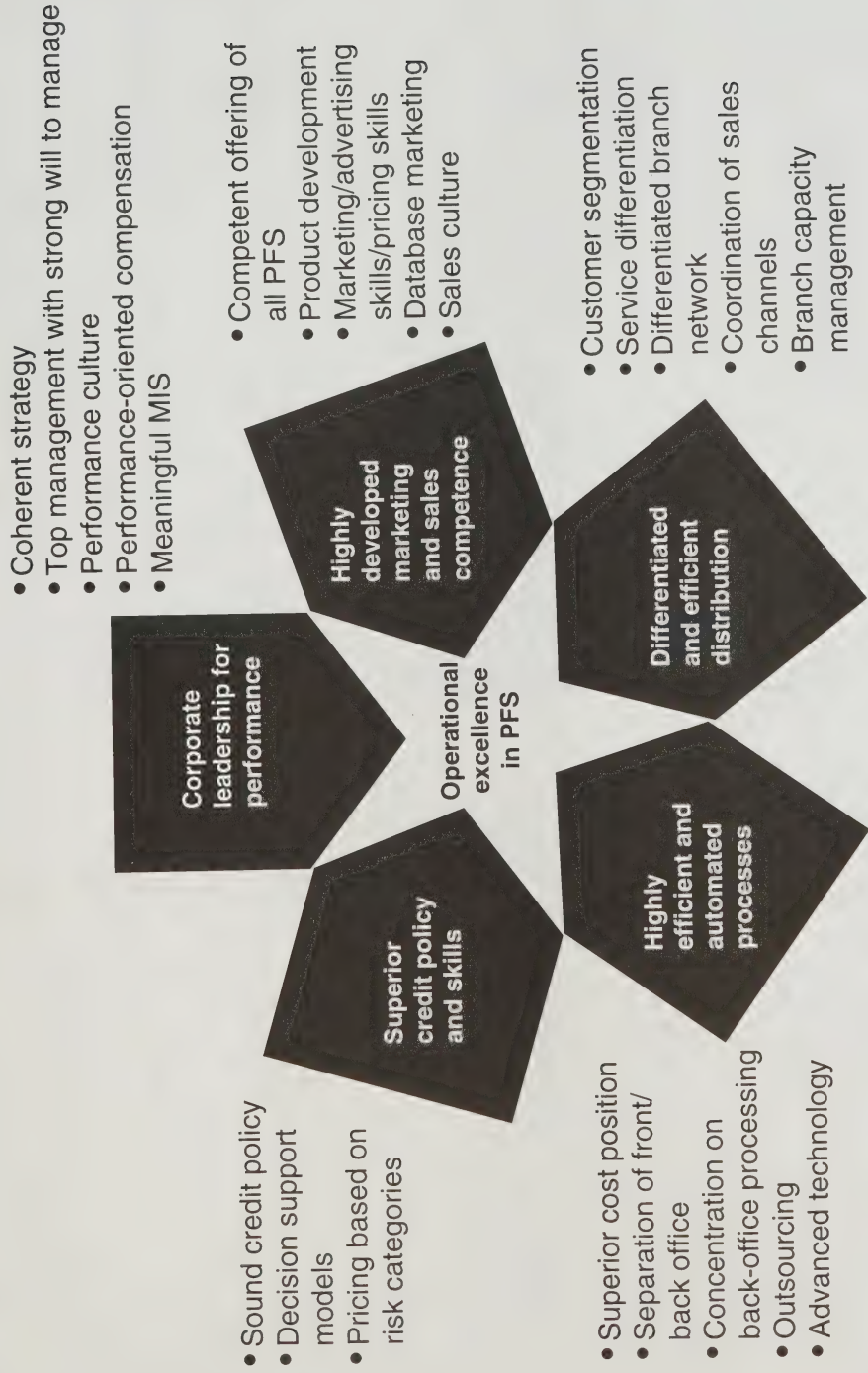
** From *Institutional Investor*

Source: *The World Competitiveness Yearbook, 1997*; IMD

SIX DIMENSIONS DRIVE BANK COMPETITIVENESS IN PERSONAL FINANCIAL SERVICES (PFS)

Operational excellence	What it is	What it gives you
Distinctive customer offer	<ul style="list-style-type: none"> • Corporate leadership for performance • Highly efficient and automated processes • Differentiated and efficient distribution • Highly developed marketing and sales competence • Superior credit policy and skills 	<ul style="list-style-type: none"> • Competitive advantage through better value delivered to customers • Financial flexibility through higher margins and market capitalization
Customer franchise	<ul style="list-style-type: none"> • Combination of product and price, usually tailored to specific customer segment needs • Customers who do not shift providers easily for cost, convenience, or other reasons • Customers loyal to a branded offering 	<ul style="list-style-type: none"> • Competitive advantage through better value delivered to customers • “Safe” market share • Lower customer acquisition costs
Size	<ul style="list-style-type: none"> • Larger customer base • Higher market capitalization 	<ul style="list-style-type: none"> • Scale efficiencies • Privileged market position • Ability to make large investments • Increased attractiveness as employer
Product scope	<ul style="list-style-type: none"> • Broad range of related products – one-stop shopping – for those customers who seek integrated delivery 	<ul style="list-style-type: none"> • Reduced unit distribution cost • Greater convenience for customers • Not as beneficial with complex products (e.g., life insurance for high-end customers)
International presence/skills	<ul style="list-style-type: none"> • International skills, operations, and contacts 	<ul style="list-style-type: none"> • Expanding set of customers, alliances, and acquisitions for globalizing products (e.g., asset management)

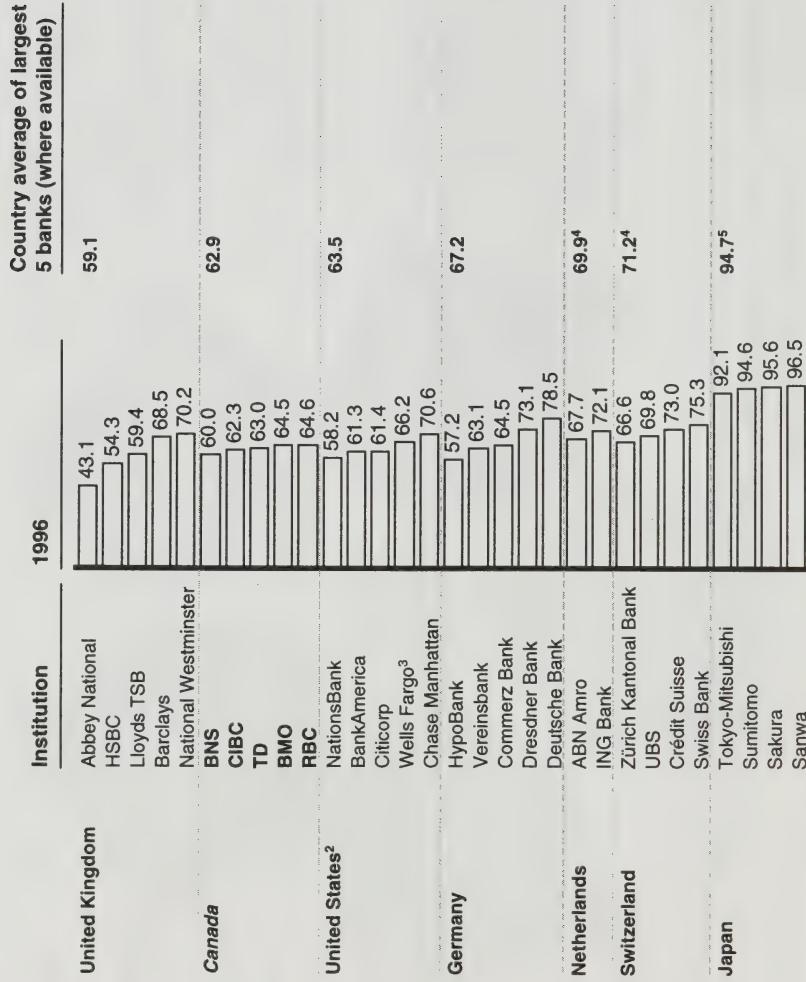
THE SUCCESSFUL PFS PROVIDER IN 2000 NEEDS TO EXCEL IN FIVE CORE COMPETENCIES



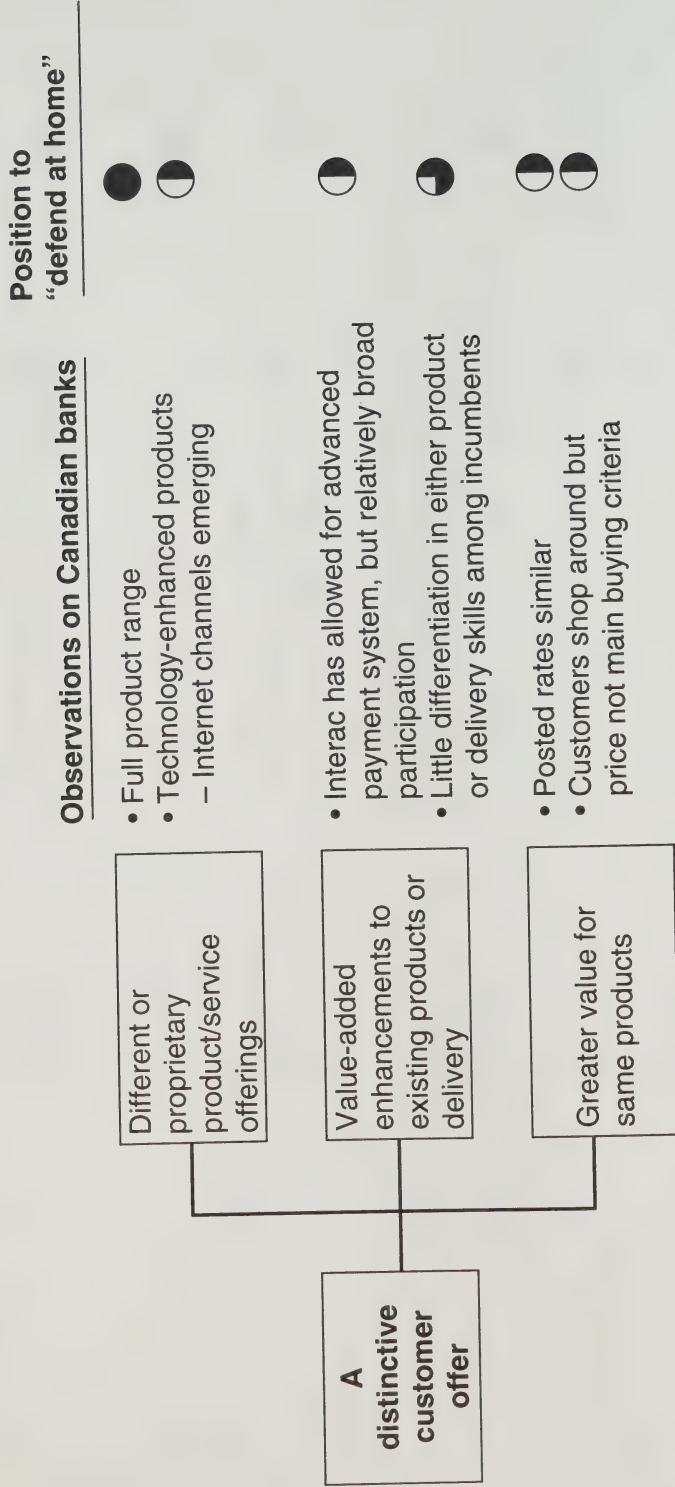
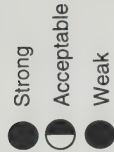
CANADIAN BANK LAGS LEADING PERFORMER IN US, UK AND GERMANY

Efficiency comparison¹

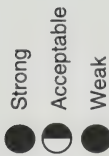
Percent

¹ Non-interest expense divided by total income² US Efficiency ratios derived from McKinsey & Company Bank Database. Common assumptions were used to calculate Efficiency Ratios across all banks. Accordingly, some figures differ from those reported in annual reports (e.g. Chase Manhattan's reported ratio is 57%)³ Excluding 1996 loan loss provision of \$105 million and First Interstate integration cost of \$440 million⁴ Average of Top 2⁵ Average of Top 4

SERVICE OFFERINGS OF CANADIAN BANKS ARE NOT DIFFERENTIATED



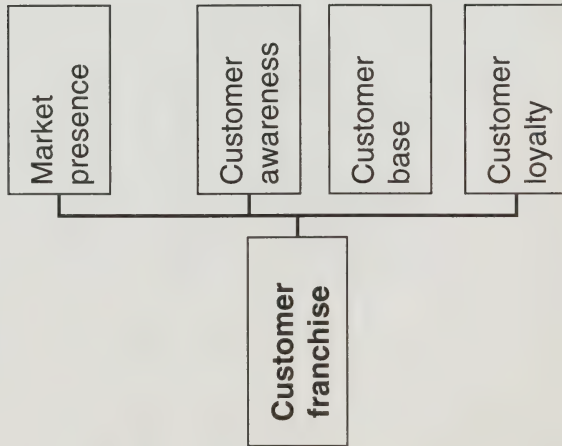
CANADIAN BANKS ENJOY STRONG CUSTOMER FRANCHISES



Position to
“defend at home”

Observations on Canadian banks

- 7,442 branches in Top 6 bank networks
- 14,484 ATMs in Top 6 bank networks but wide access available to all providers through Interac Network
- Near universal recognition, but unclear value to their brand positions signals little to customers
- Leading share in core PFS products
- No institution has gained more than 1% market share/year except through acquisition

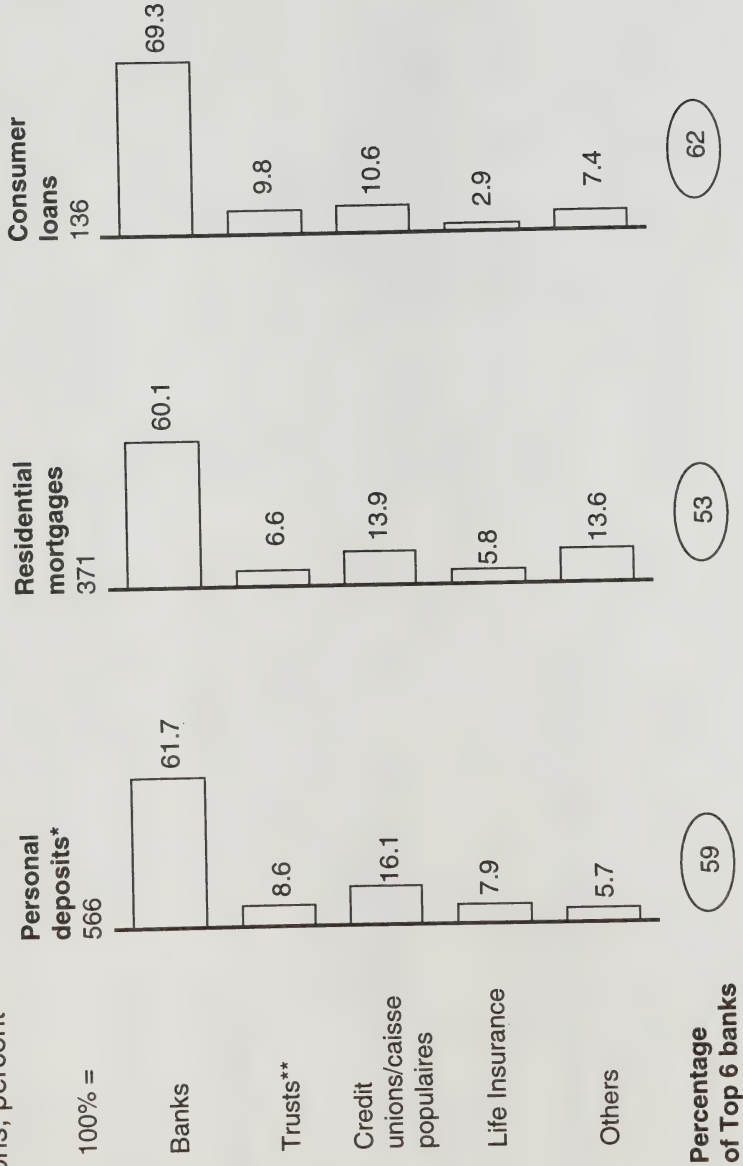


BANKS HOLD THE DOMINANT SHARE IN DEPOSITS, RESIDENTIAL MORTGAGES, AND PERSONAL LOANS

ESTIMATES

Product concentration 1997

Cdn \$ Billions, percent



* Excludes foreign currency deposits; includes personal notice and demand deposits plus life insurers' individual annuities and money market mutual funds

** Independent, includes Canada Trust

Source: Bank of Canada; OSFI; annual reports; Canadian Insurance; McKinsey & Company analysis

SIZE CAN HELP IN PFS

Economies of scale and scope are real...

Scale efficiencies

- More efficient physical distribution
- Lower per unit processing costs
- Critical mass for tailoring product/service offerings

Market position

- Ability to invest in brand
- Ability to get distribution shelf space

Financial strength

- Larger market capitalization or investment capital to acquire capabilities or market positions

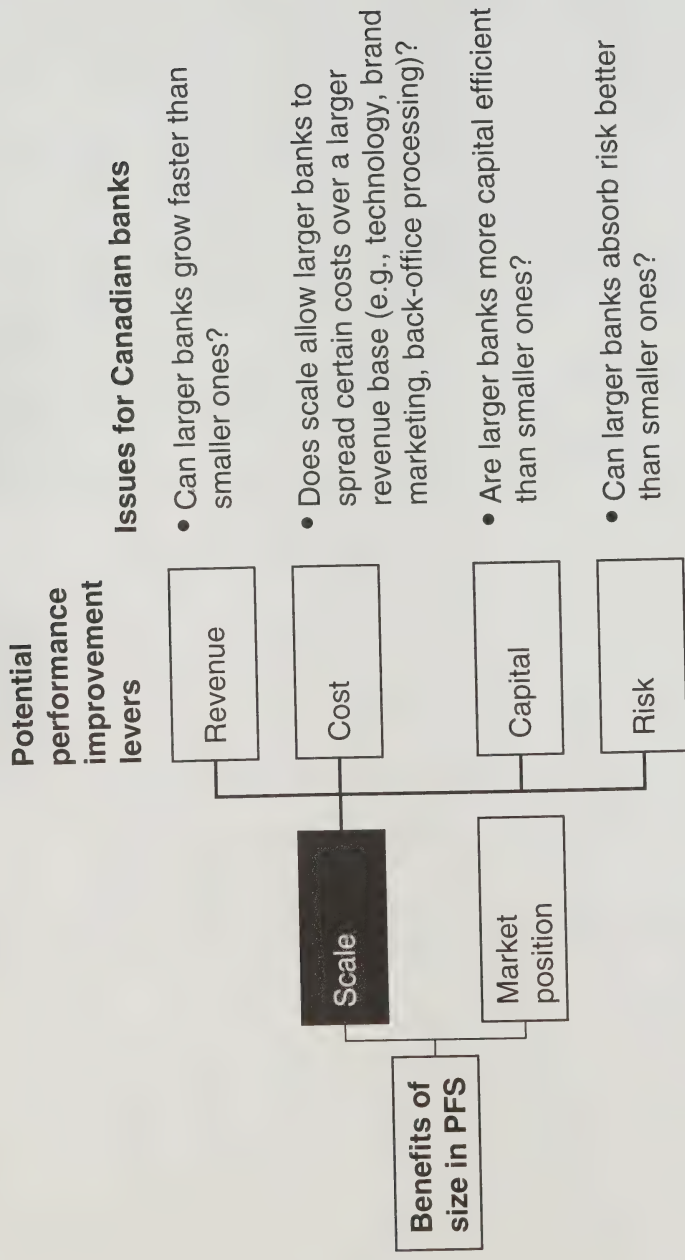
Recruiting power

- Ability to attract, develop, or retain truly world-class talent

...but are not
captured in every
case

- Increased complexity
- Market circumstances
- Organizational capabilities

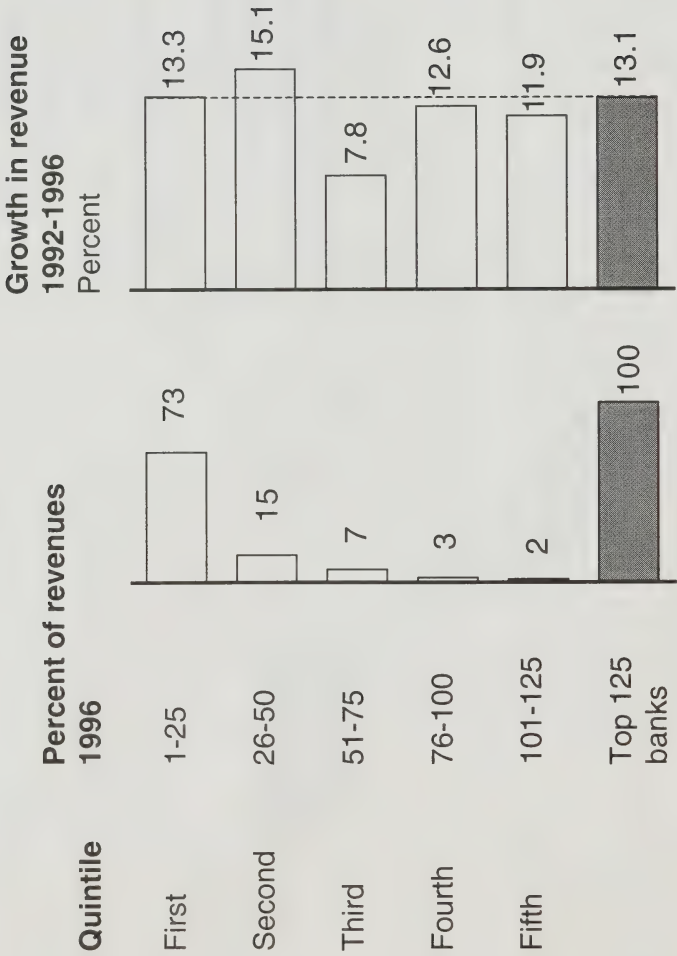
ONE BENEFIT OF SIZE IS SCALE EFFICIENCY



THE LARGEST US BANKS ARE NOT THE FASTEST GROWING

Revenue

Revenue for Top 125 US banks*

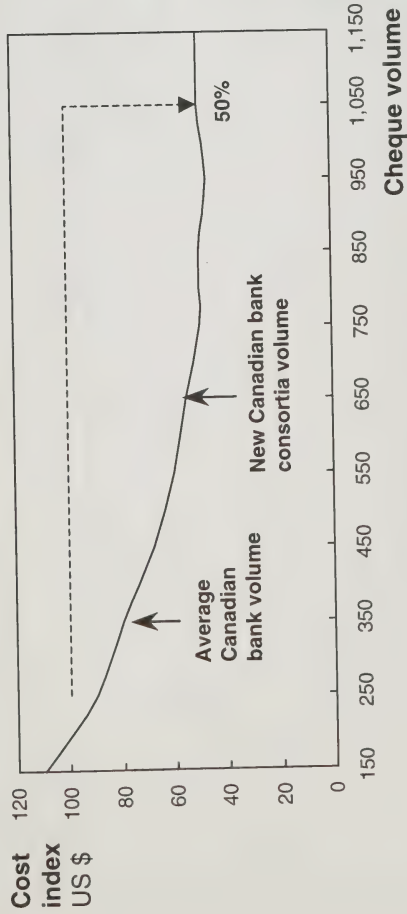


* Ranked by asset size
Source: McKinsey & Company Global FIG Practice

SCALE MATTERS IN BACK-OFFICE PROCESSING – BUT ONLY TO A POINT

Cost	

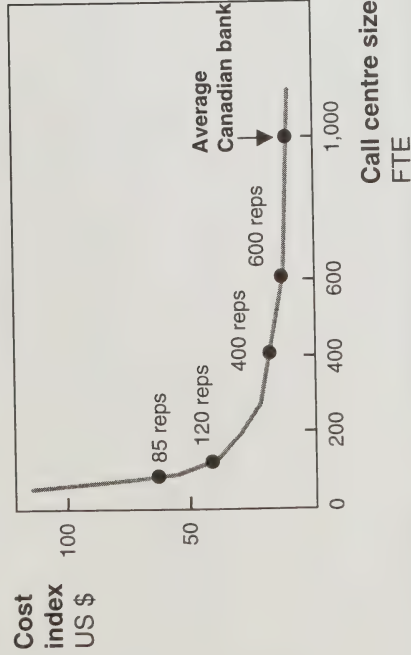
Cheque processing cost



Observations

- The Canadian cheque clearing consortia demonstrates creative solutions to reduce back-office processing costs without merging the banks
- Beyond a certain size returns diminish with increased scale
- Canadian banks have already reached minimum efficient scale in call centres

Fixed cost per call by call centre size

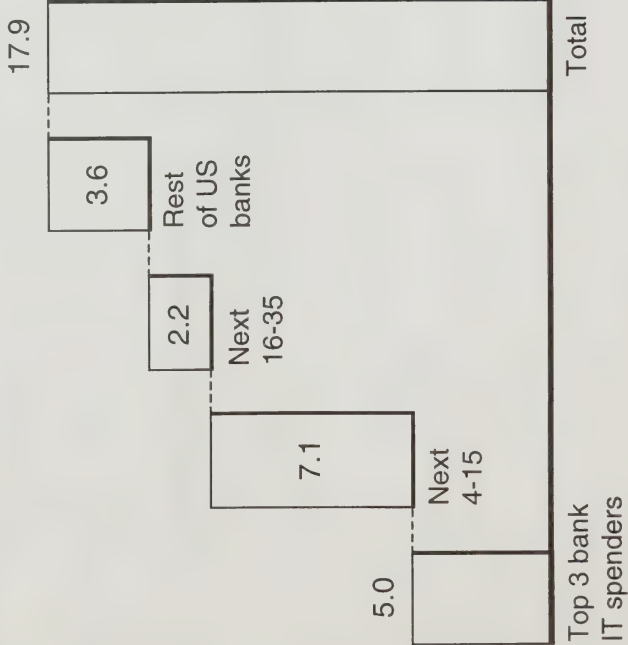


IN ABSOLUTE, CANADIAN BANK IT SPENDING IS SMALL COMPARED TO THAT IN THE US

ESTIMATES

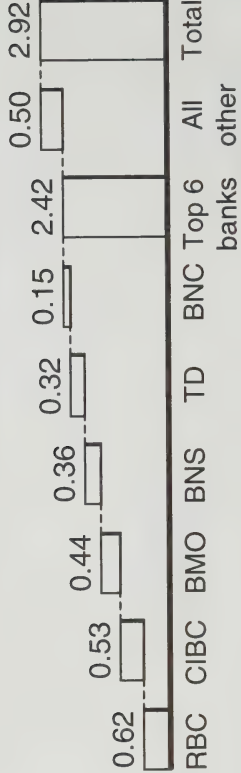
IT spending by US banks 1996

US \$ Billions



IT spending by Canadian banks 1996

US \$ Billions

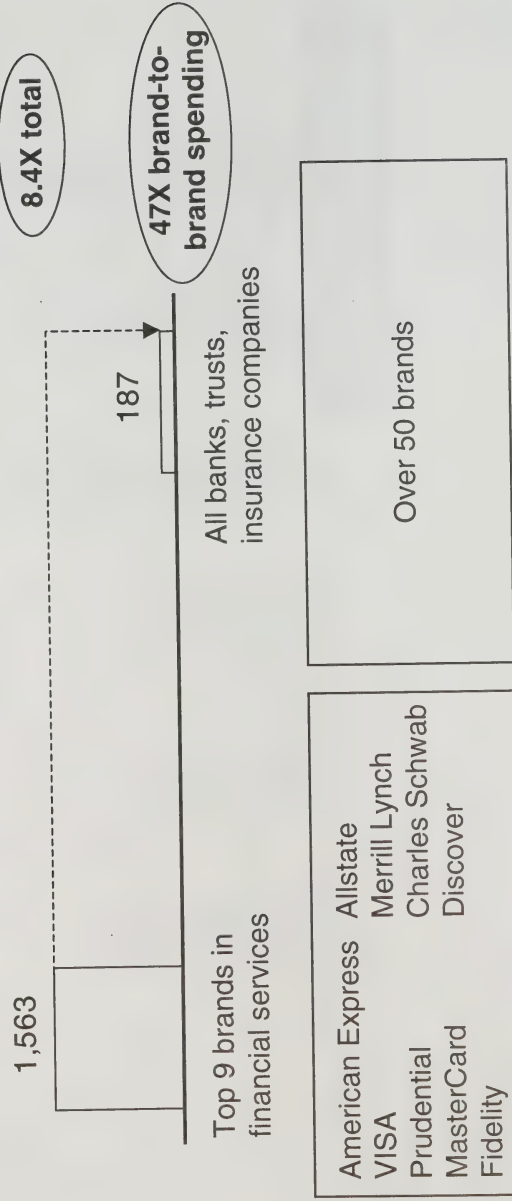


CANADIAN SPENDING IS INSUFFICIENT TO SUPPORT GLOBAL BRANDS

ESTIMATES

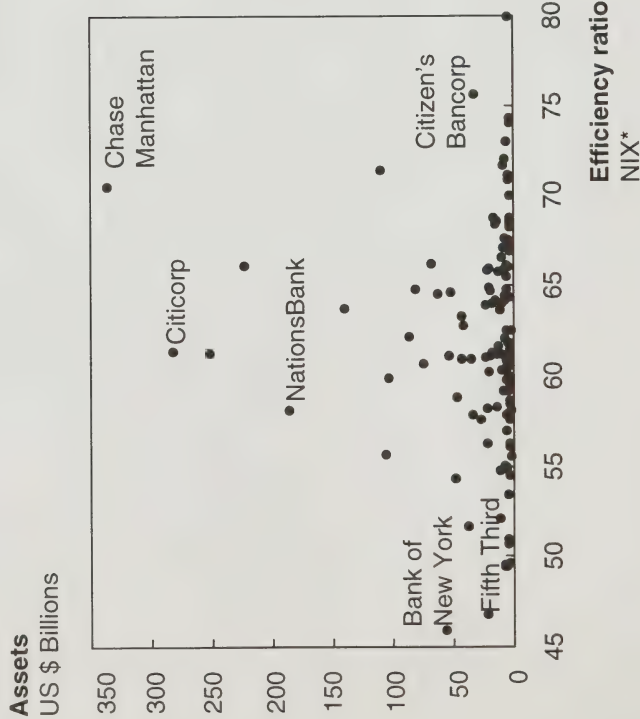
Total brand advertising
Cdn \$ Millions

Top 9 US brands 1996 *Canadian financial services 1994*



SIZE IS NOT A PREDICTOR OF EFFICIENCY IN THE US

Top 125 US banks 1996



Potential scale advantages may not be captured

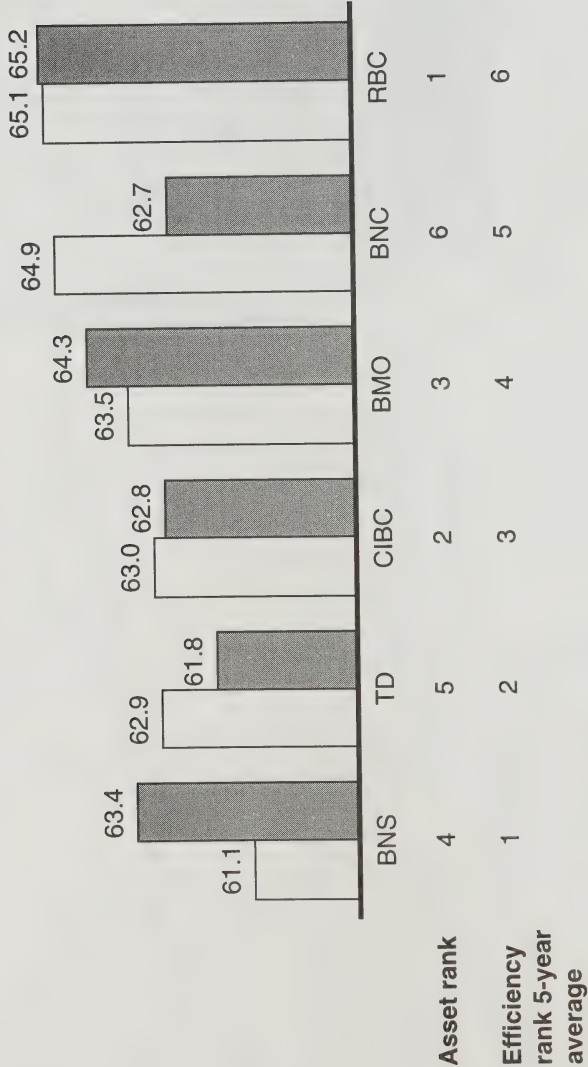
- Management failure
 - Lack of will/skill to get cost out
 - Lengthy/problematic merger integration (if applicable)
- Competitors outsourcing scale-driven operations
- Already beyond efficient scale
- Brand advantage not relevant

* Non-interest expense/operating revenue
Source: McKinsey & Company Global FIG Practice

SIZE DOES NOT CORRELATE WITH EFFICIENCY IN CANADA, EITHER

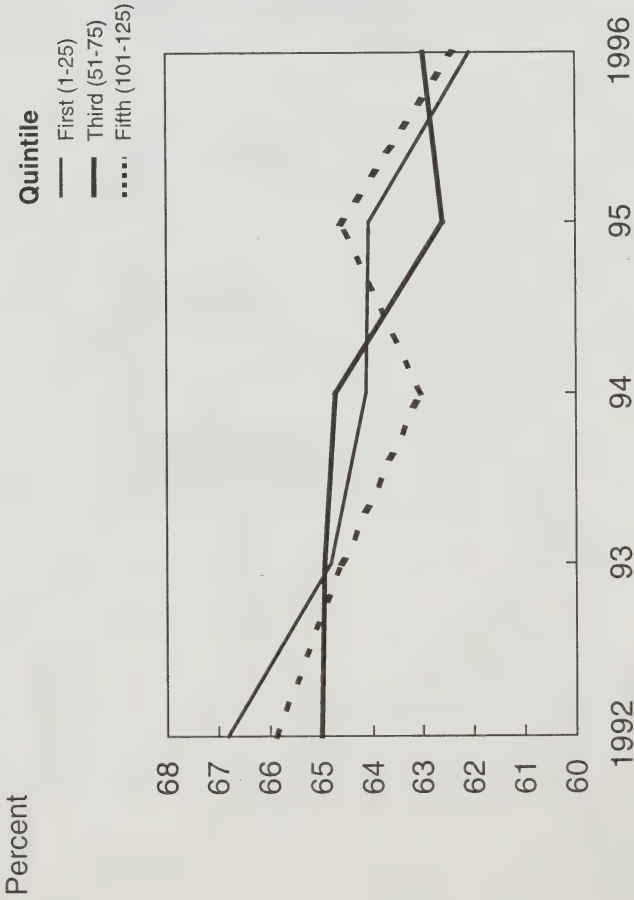
5-year average (1992-97)
1997

Efficiency ratios
Percent

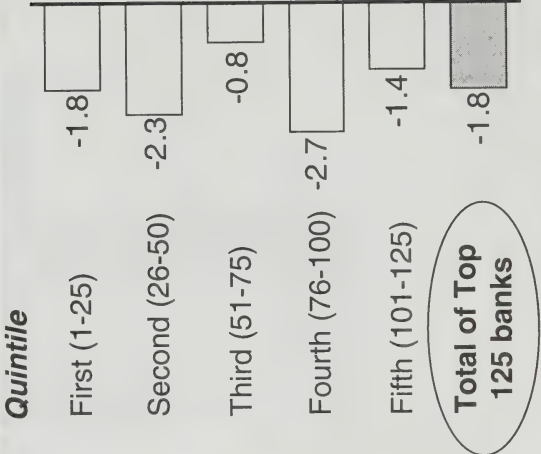


THE BANKING SECTOR, AS A WHOLE, IS BECOMING MORE EFFICIENT

Efficiency ratio (NIX)* for Top 125 US banks



Improvement in NIX 1992-96
Percent



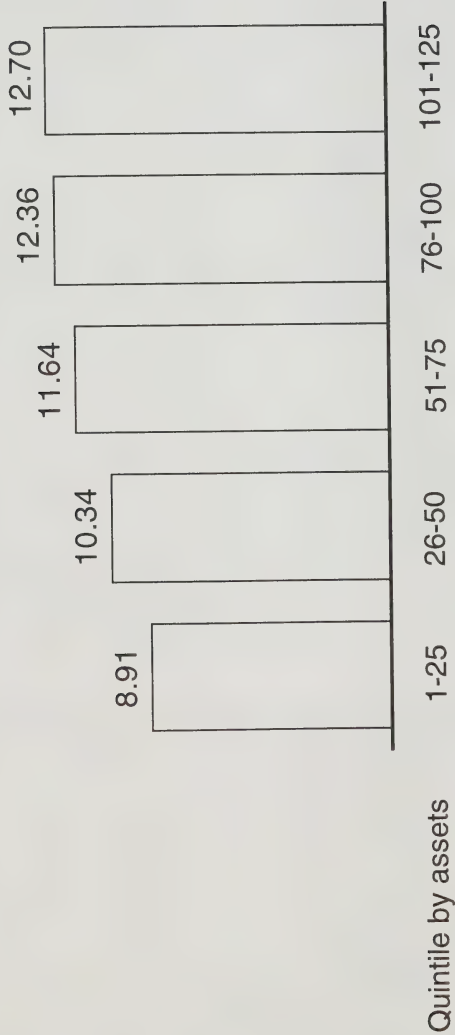
* Non-interest expense/operating revenue

THE LARGEST BANKS ARE MORE CAPITAL EFFICIENT

US EXAMPLE

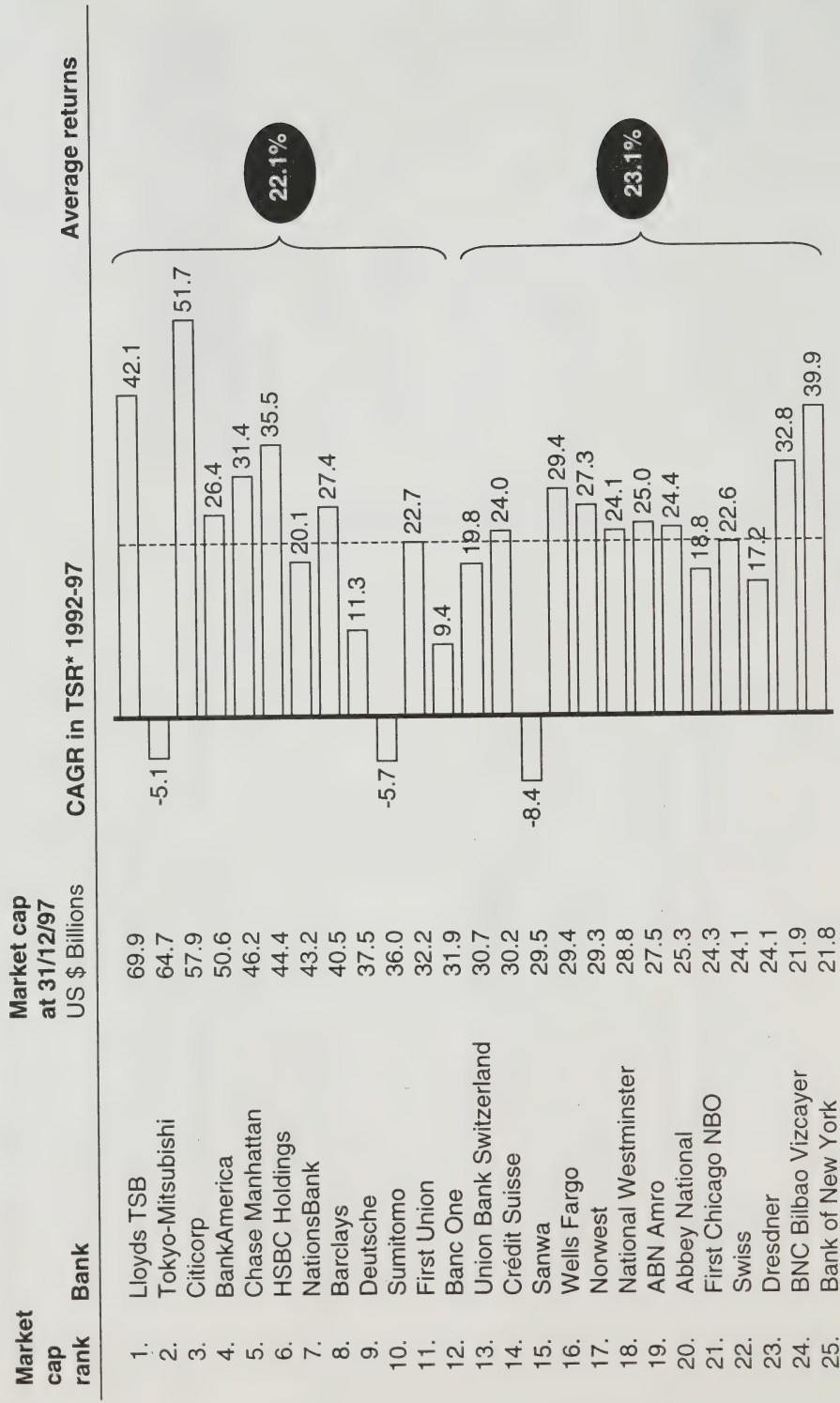
Capital

Tier one capital ratio* for Top 125 US banks
5-year group average (1992-96), percent



* Risk weighted assets/core capital
Source: McKinsey & Company Global FIG Practice

SIZE DOES NOT NECESSARILY RESULT IN BETTER RETURNS TO SHAREHOLDERS



* Total shareholder returns

Source: The Banker, Datastream

SCALE CAN MITIGATE IMPACT OF RISK IN A BANK'S OPERATIONS

Risk

High impact

Low impact

Risk category	Description/examples	Scale's impact on the ability to absorb risk
Credit	<ul style="list-style-type: none">• Default• Country/political• Counterparty	<div><div></div></div>
Market	<ul style="list-style-type: none">• Performance• Prepayment• Liquidity• Rate• Spread• Basis• Currency	<div><div></div></div>
Operations	<ul style="list-style-type: none">• System failure• Settlement	<div><div></div></div>
Environmental	<ul style="list-style-type: none">• Natural disaster• Regulatory/legal• Tax• Social	<div><div></div></div>
Behavioural	<ul style="list-style-type: none">• Fraud<ul style="list-style-type: none">– Between institutions– Within institutions• Staff errors	<div><div></div></div>

CANADIAN BANKS OFFER A FULL RANGE OF PFS PRODUCTS AND SERVICES

Example of select
TD services

Full range of PFS products

Payments

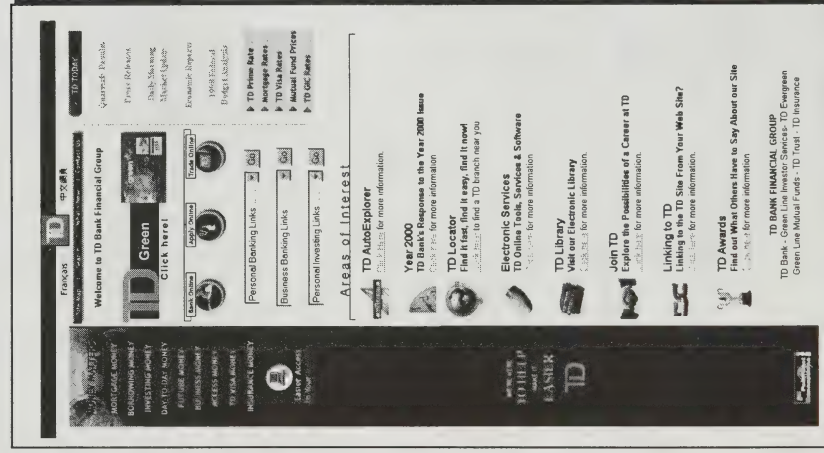
- Chequing accounts
- Travelers cheques
- Debit card

Credit

- Personal loans
- Credit lines
- Mortgages
- Credit cards
- Overdrafts

*Asset
accumulation*

- Savings accounts
- Mutual funds
- Term deposits
- RRIFs
- RSP
- Securities

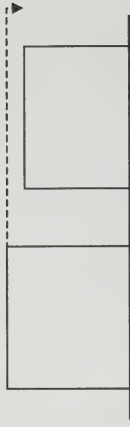


**But Canadians increasingly
find one-stop shopping less
appealing**
Percent of respondents

Very appealing

33

28



Not appealing at all

9

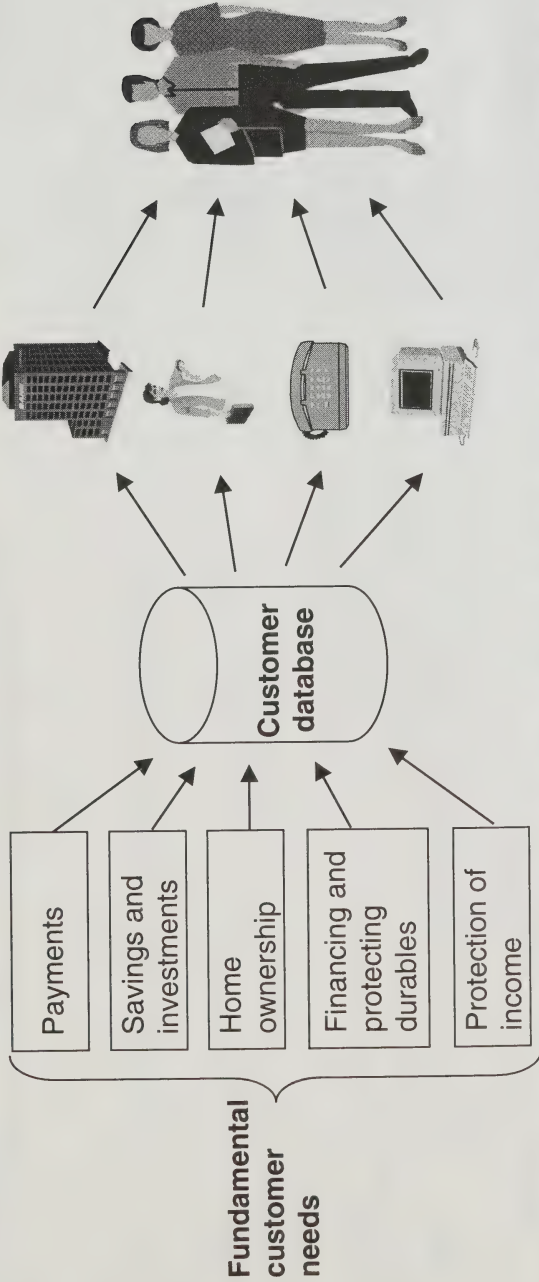
15



1986

1997

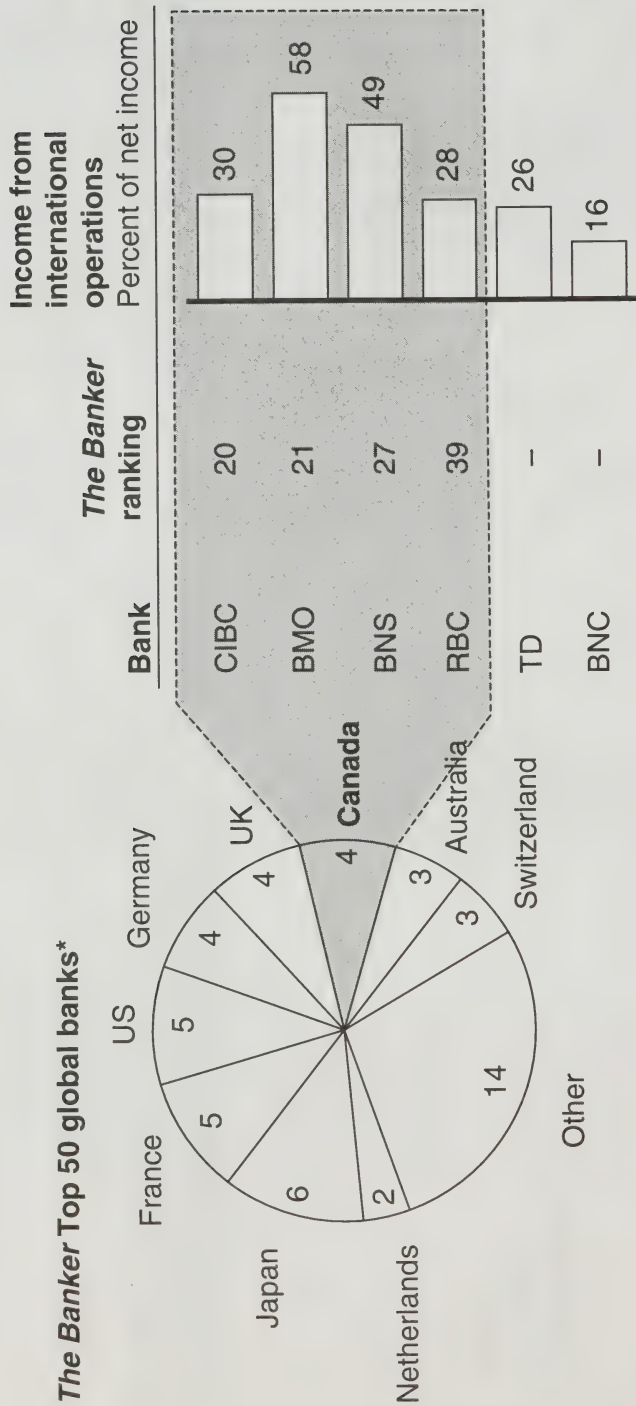
FULL PRODUCT RANGE OF CANADIAN BANKS ALLOWS FOR ECONOMIES OF SCOPE



Economies of scope in	Products/services	Information	Channels	Customer franchise
	<ul style="list-style-type: none"> • Regrouping of products based on needs/events across traditional product lines to serve customers in an integrated fashion 	<ul style="list-style-type: none"> • Informational advantage of different observations on customer needs/behaviours 	<ul style="list-style-type: none"> • Increased convenience by offering different channels • Possibility to differentiate service through broader array of choices 	<ul style="list-style-type: none"> • Increased share of wallet of existing customers in a maturing, more competitive market • Ability to serve different segments

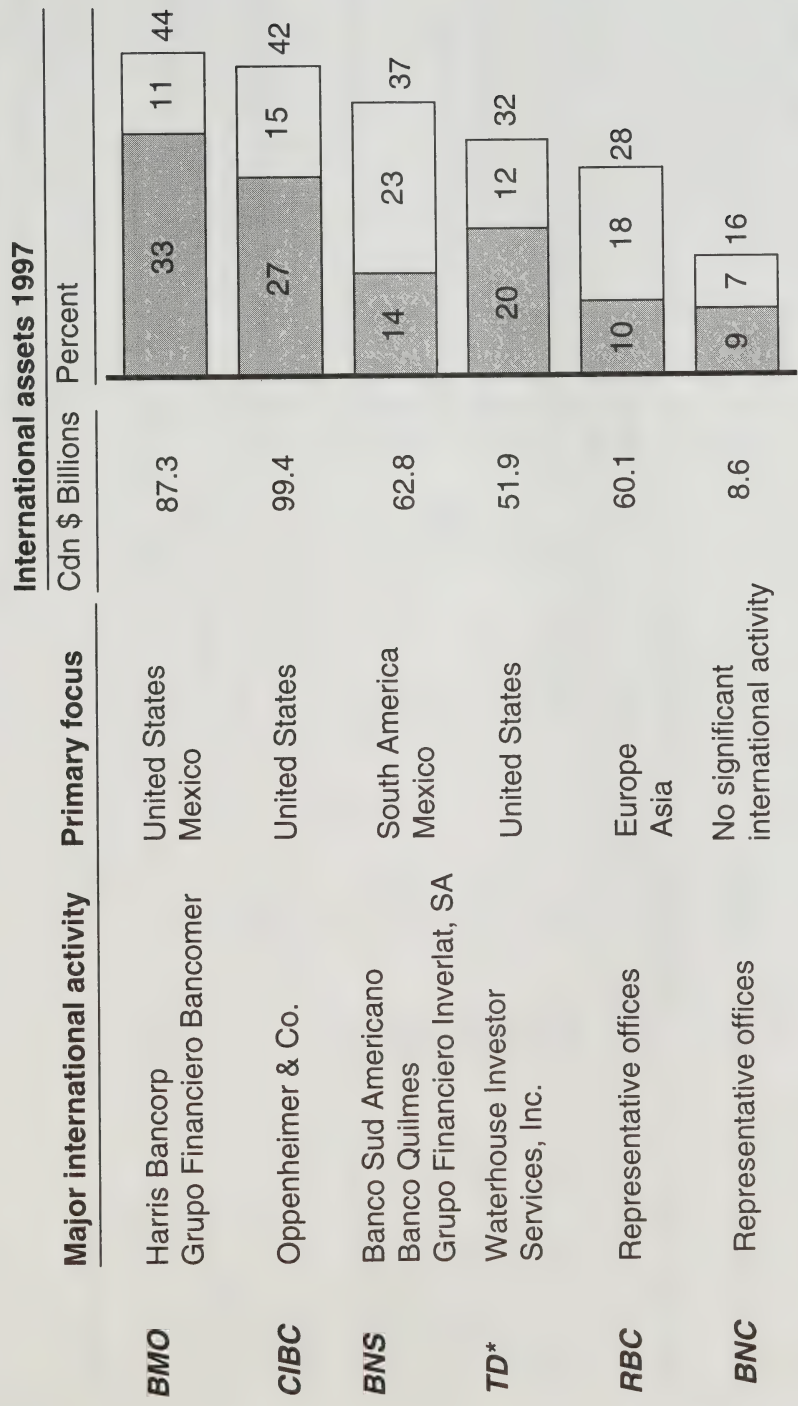
CANADIAN BANKS HAVE AN ESTABLISHED INTERNATIONAL PRESENCE

The Banker Top 50 global banks*




* Top 50 determined by percentage of assets and revenues-based overseas
Source: *The Banker*, annual reports

INTERNATIONAL ACTIVITY AND FOCUS VARY BY INSTITUTION




* Breakdown based on average earning assets
Source: Annual reports

GLOBALIZATION OF WHOLESALE BANKING IS EFFECTIVELY COMPLETE

L = Local (Canada)
R = Regional (North America)
G = Global
 = Becoming global

Line of business	Arena of competition		Degree of competitiveness today	Rationale
	Today	5-10 years		
Wholesale				
• M&A/corporate finance	G	G	High	• Law of one price worldwide
• Fixed income	G	G	High	• Large global players
– Investment grade				• Declining margins/spreads
– High yield				• Scale economies in risk management, technology
• Foreign exchange	G	G	High	• Global customer base
• Derivatives	G	G	Medium	• Facilitated by increased capital mobility
• Commodities	G	G	High	
Midmarket				
• Commercial	L	G	Medium	• Commercial large will globalize as capital markets become more accessible
– Leasing	L	R/G	Low/medium	• Commercial medium will remain regional because of size of market and dependence on credit-based instruments
– Medium	G	G	High	
– Large				
Small business	L	L/R/G?	Low/medium	• Market for start-up businesses will remain local
				• Globalization of existing market depends on technology, ability to unbundle, and incumbent moves






GLOBALIZATION OF PFS IS STARTING TO EMERGE

L = Local (Canada)
R = Regional (North America)
G = Global
 = Becoming global

Line of business	Arena of competition			Rate of change	Rationale
	Today	5-10 years			
Basic banking					
• Branch-based	L	L/R		Fast	• Entrants will not build many branches
• Electronic	L/R	R/G		Very fast	• Limited entry and technology barriers
Asset management					
• Distribution	L	L/R		Fast	• Relationship-based
• Manufacturing	L/R	G		Fast	• Scale economies
Cards	R	G		Fast	• Aggressive specialized global players
Mortgages	L	R		Medium	• Rapidly consolidating/eroding entry barriers
Life insurance	L	R/G		Medium	• Wave of consolidations/remote offers
Processing	L/R	G		Very fast	• Massive scale/skill economies

PREVIOUSLY FORMIDABLE BARRIERS TO PFS GLOBALIZATION ARE WEAKENING

● High vulnerability
○ Low vulnerability

Barrier	Description	Observations on sustainability	Assessment of vulnerability*
Regulation	<ul style="list-style-type: none">● Restrictions on<ul style="list-style-type: none">– Range of domestic activity– Market access– Ownership– Cross-border financial services– Cross-border capital flows	<ul style="list-style-type: none">● World Trade Organization focus area● Under review in many countries	
Access to retail distribution	<ul style="list-style-type: none">● Large upfront investments required to build a branch network and transaction systems	<ul style="list-style-type: none">● Costly to build but can be bought or acquired through alliances	
Skills	<ul style="list-style-type: none">● Market skills, techniques, methodologies (risk assessment, pricing) still at different stages of development in international markets	<ul style="list-style-type: none">● Can result in global war for talent● BIS addressing some issues	
Access to information	<ul style="list-style-type: none">● Transparency of information and accounting standards vary widely	<ul style="list-style-type: none">● BIS focus area● Infrastructure will be built long term	
Customer loyalty	<ul style="list-style-type: none">● Strong institutional and personal relationships between banks and customers	<ul style="list-style-type: none">● Difficult to break grip of local players	

* Subjective assessment
Source: McKinsey & Company Global FIG Practice

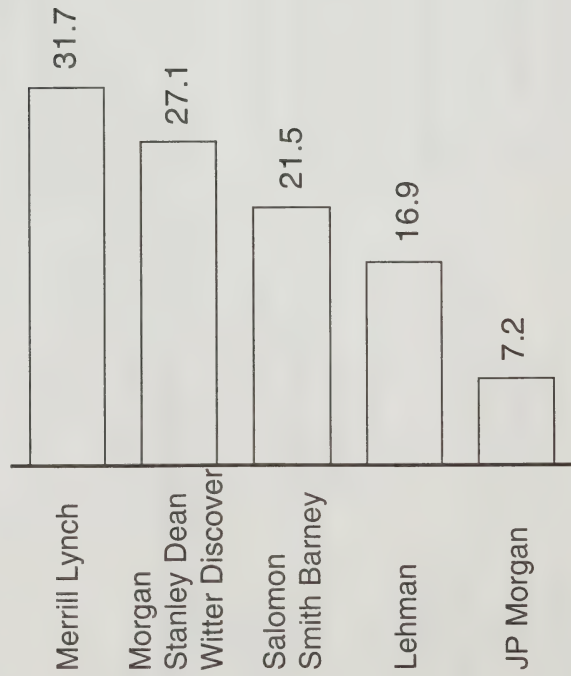
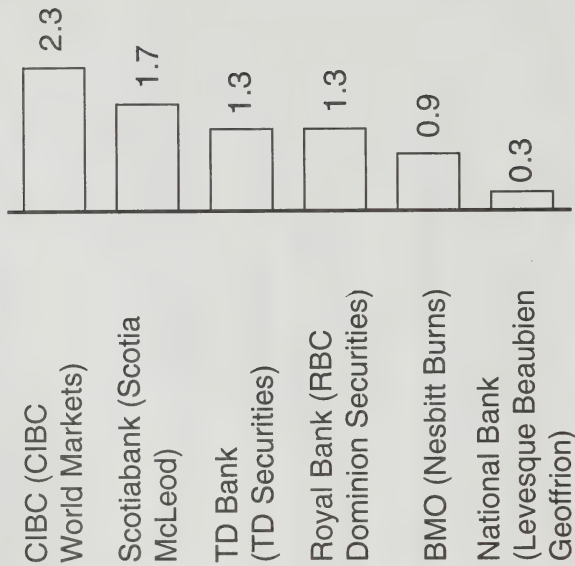
CANADA'S BANKS ARE NOT WELL POSITIONED TO COMPETE IN PFS ABROAD

Today

Operational excellence	<input checked="" type="checkbox"/> "Specialists always win" <input checked="" type="checkbox"/> Undistinguished productivity and quality levels <input checked="" type="checkbox"/> Legacy technology still inhibiting rapid innovation <input checked="" type="checkbox"/> Challenges in attracting truly world-class talent
Distinctive customer offer	<input checked="" type="checkbox"/> Value propositions still broadly targeted <input checked="" type="checkbox"/> Not yet world-class in database marketing <input checked="" type="checkbox"/> Relatively weak in asset management
Customer franchise	<input checked="" type="checkbox"/> No meaningful international presence
Size	<input checked="" type="checkbox"/> Relatively small <input checked="" type="checkbox"/> Low market capitalization
Product scope	<input checked="" type="checkbox"/> Depends on entry strategy
International presence/skills	<input checked="" type="checkbox"/> With few exceptions, no substantial experience in foreign markets

*Wholesale banks***CANADA'S WHOLESAL PLAYERS ARE RELATIVELY SMALL**

1997 revenue
US \$ Billions

Global winners**Canadian wholesale banks***

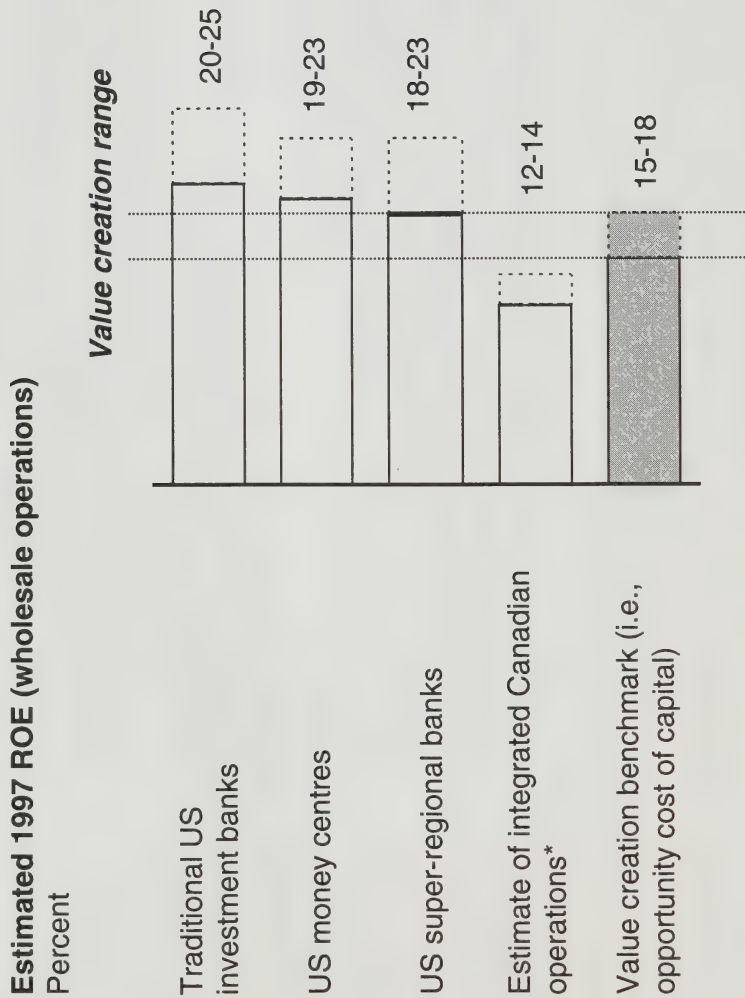
* Investment dealers in parenthesis
Source: Annual reports; Bloomberg

OUTSTANDING MANAGEMENT PROCESSES
CHARACTERIZE WINNERS IN WHOLESALE BANKING

Key success factor	Motivation
Operational excellence	<ul style="list-style-type: none">• Large downside of operational deficiencies• Operational cost control contributing to superior returns
Outstanding risk and performance measurement systems	<ul style="list-style-type: none">• Gives competitive edge in risk return decision making, which is a key success factor in capturing new market opportunities as they emerge• Improves risk control, which is increasingly important to avoid excessive risk concentration (e.g., counterparty risk)• Allows alignment of rewards and risk-adjusted returns to provide the right incentives to employees (e.g., risk capital allocation down to the individual trader)
Flexibility in deployment of labour and capital	<ul style="list-style-type: none">• Enables new opportunities to be grasped quickly• Protects overall returns by rapidly downsizing non-performing activities (through head count reduction or redeployment)
Partnership-like organization	<ul style="list-style-type: none">• Best organizational form to accommodate large numbers of talented individuals (flat-shaped organization)• Partnership-like compensation (e.g., through “virtual equity”) aligning individual and firm goals• Stimulates entrepreneurship required to develop new market opportunities• Enables leveraging of cross-firm skills and knowledge

CANADIAN WHOLESALERS PLAYERS NOT CREATING VALUE

ESTIMATES



* Corporate credit and capital-raising and advisory service
Source: McKinsey & Company Global FIG Practice

FOUR KEY FACTORS AFFECT COMPETITIVENESS IN LIFE INSURANCE

What it gets you

Newly competitive market offerings

- Distinctive and focused customer offer
- Renewed traditional agent channel
- Multichannel capability
- Merchandising capability
- Channel segmentation capability
- Asset accumulation and distribution products

Size in operations

- Scale efficiencies
- Fund expansion into less-developed markets

Flexibility to grow

- Demutualization
- M&A skills
- Willingness to offer marketable business systems capabilities to other industry players (e.g., banks)

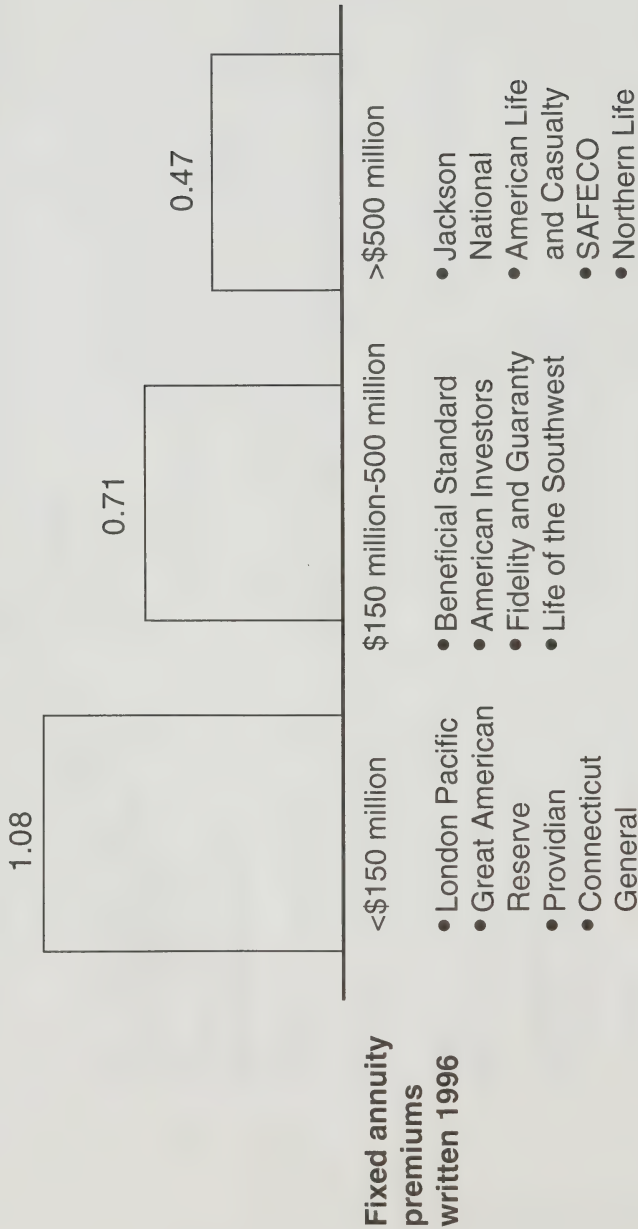
Renewed management approach

- Rigorous management of key value drivers by business line
- Alignment of organization and infrastructure with focused customer offer

SCALE CAN LOWER UNIT COSTS AS SHOWN IN INDEPENDENT AGENTS' EXPERIENCES

US EXAMPLE

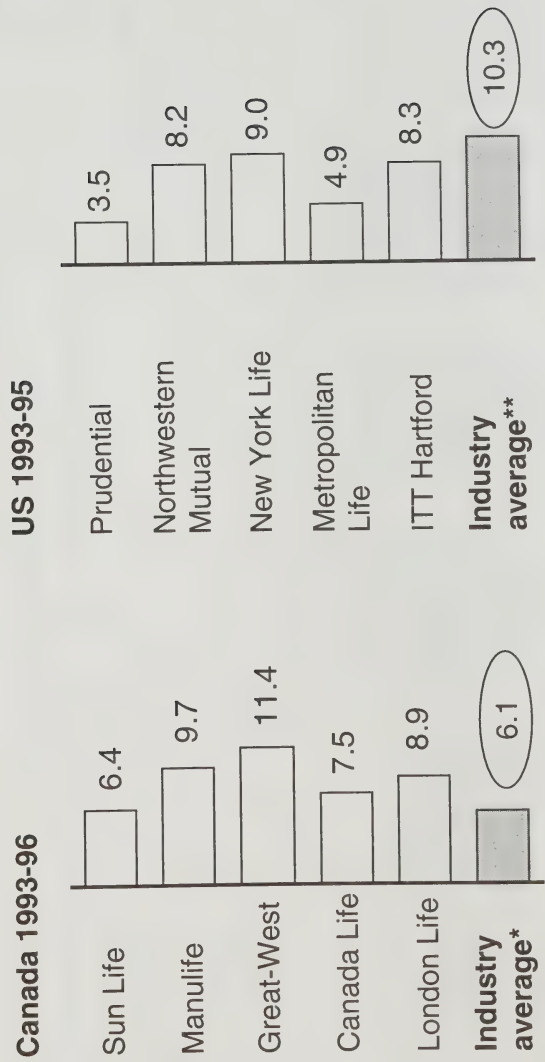
Individual annuity expense ratio (weighted)
Percent



Fixed annuity
premiums
written 1996

CANADA'S LARGEST LIFE INSURERS' ROEs EXCEED THE INDUSTRY AVERAGE

Top 5 players
Percent

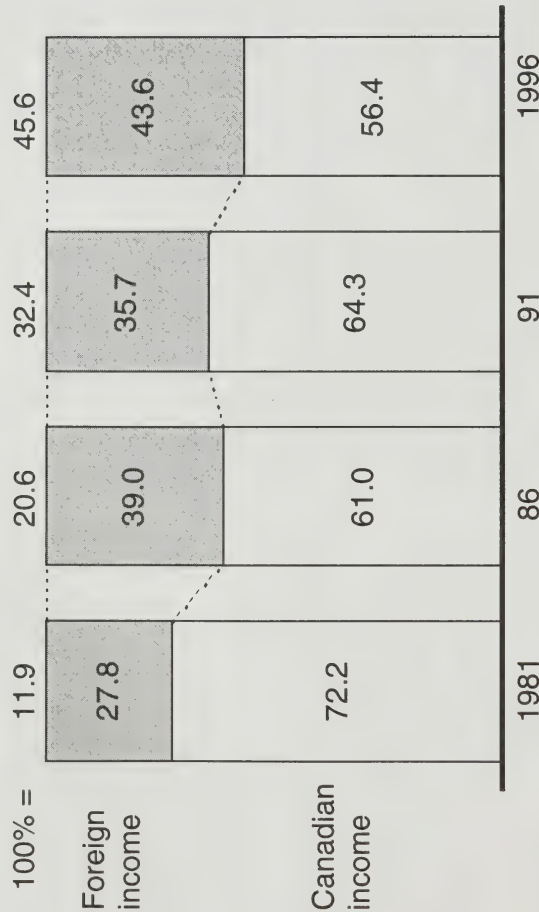


* Based on average ROE for Top 20 firms in Canada

** Total US life and health insurance industry average

PREMIUM INCOME INCREASINGLY IS COMING FROM FOREIGN OPERATIONS**Premium income**

Cdn \$ Billions



CANADA'S LIFE INSURERS HAVE MIXED COMPETITIVE POSITIONS BOTH AT HOME AND ABROAD

- ☒ Competitive
☒ Vulnerable

Select observations

Defending at home

- ☒ Tough to beat in traditional products and channels
- ☒ Potentially threatened if
 - New forms of distribution such as banks and direct or electronic channels are successful
 - Dramatic product mix shifts to “term and invest the rest”

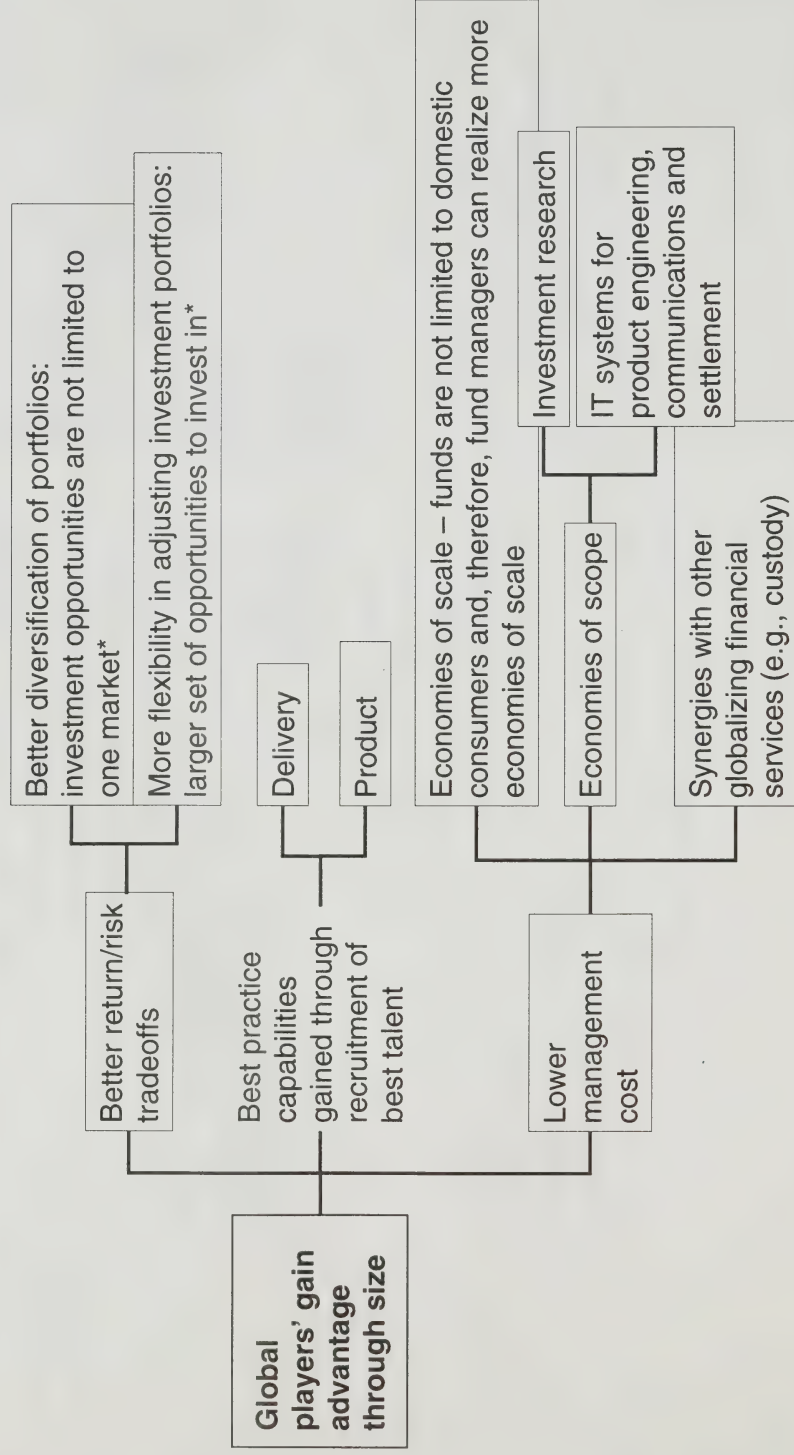
Top 6 have very strong position – with Bancassurance as the only major threat

Competing abroad

- ☒ Not facing large number of distinctive players – only a handful are truly international
- ☒ Have significant non-Canadian experience and real strengths in some developing markets on institutional basis but no clear distinctiveness
- ☒ Middle of the pack in developed markets

Significant international presence, some pockets of distinctiveness, but generally middle of the pack

ASSET MANAGERS BENEFIT FROM SCALE

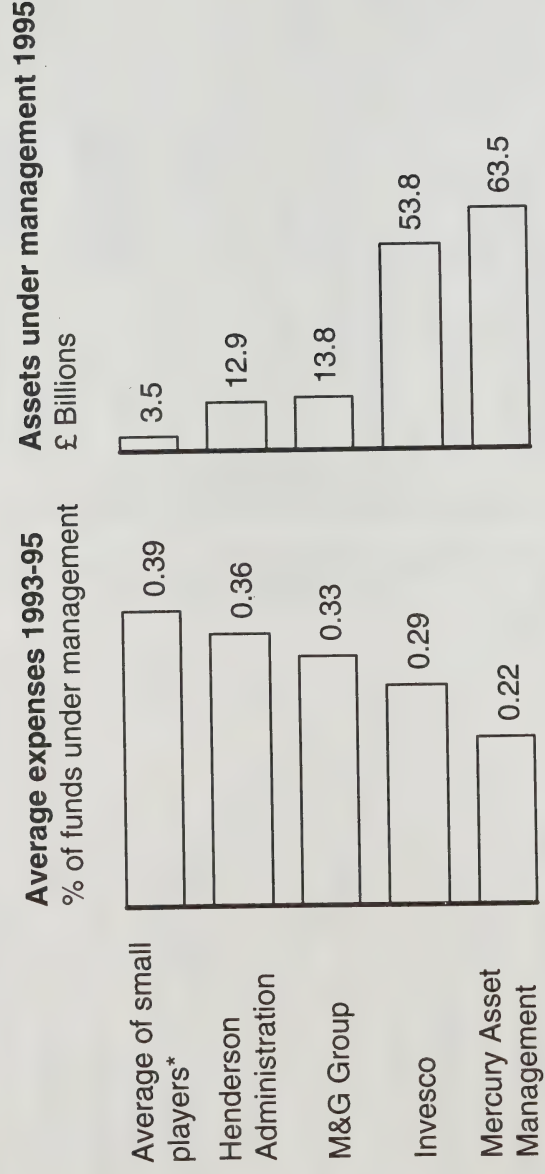


* To the extent that the client delegates the asset allocation to a fund manager

UK EXPERIENCE SUGGESTS THAT ECONOMIES OF SCALE CAN INDEED BE REALIZED

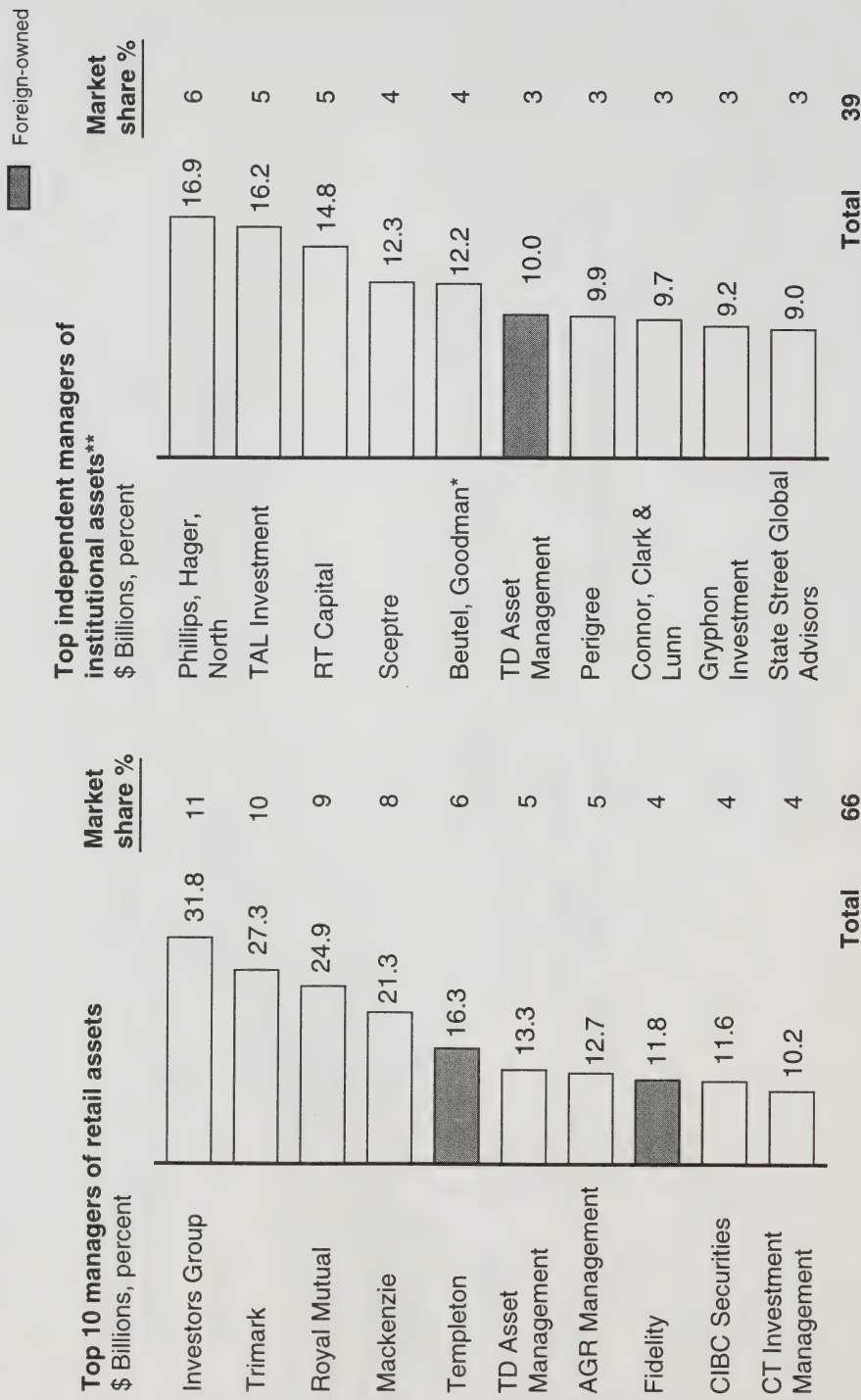
UK EXAMPLE

UK fund managers



* Aberdeen Trust, Ivory & Sime, Edinburgh Fund Managers, Perpetual
Source: McKinsey & Company analysis; HSBC James Capel report

CANADIAN ASSET MANAGEMENT BUSINESS IS RELATIVELY FRAGMENTED

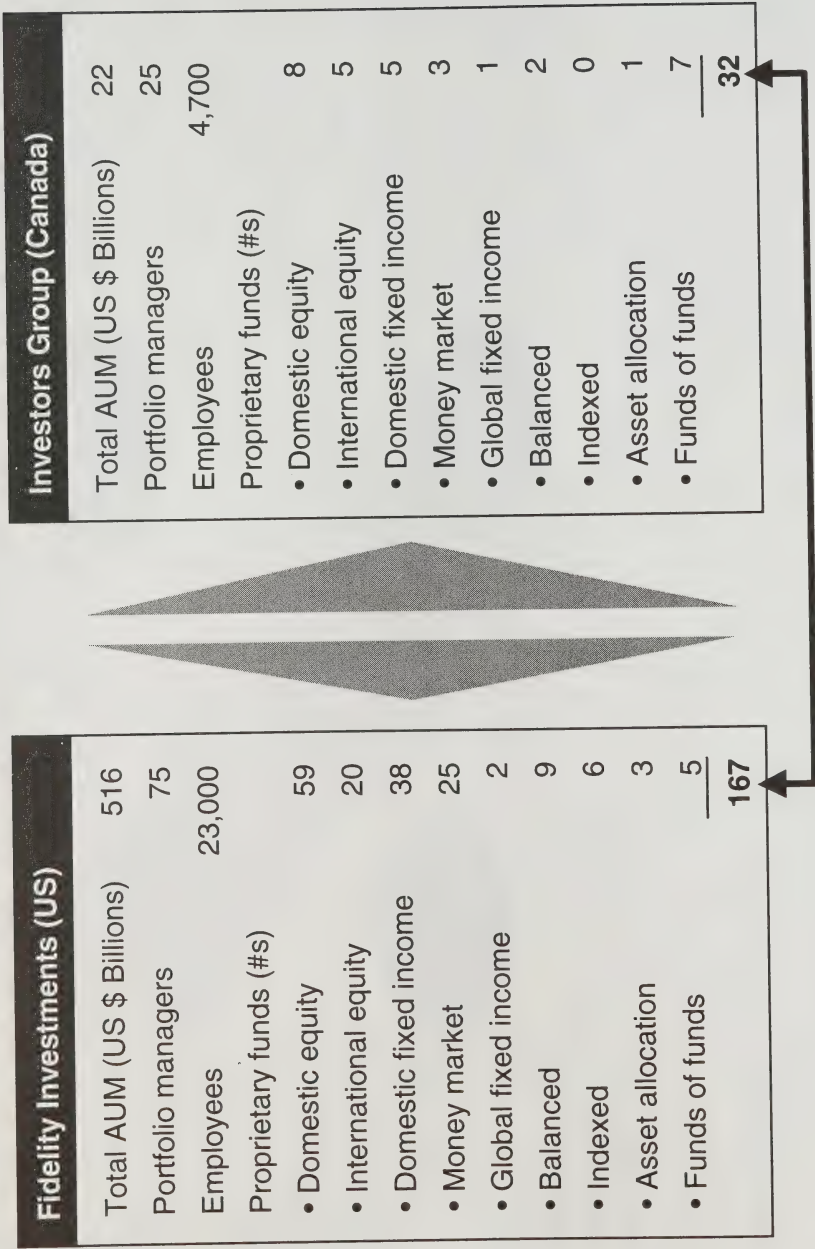


* Owned by Phoenix, Duff & Phelps

** Caisse de dépôt et placement du Québec is excluded because it is a "captive manager" for the Quebec Government pensions
Source: IFIC; Benefits Canada; McKinsey & Company analysis

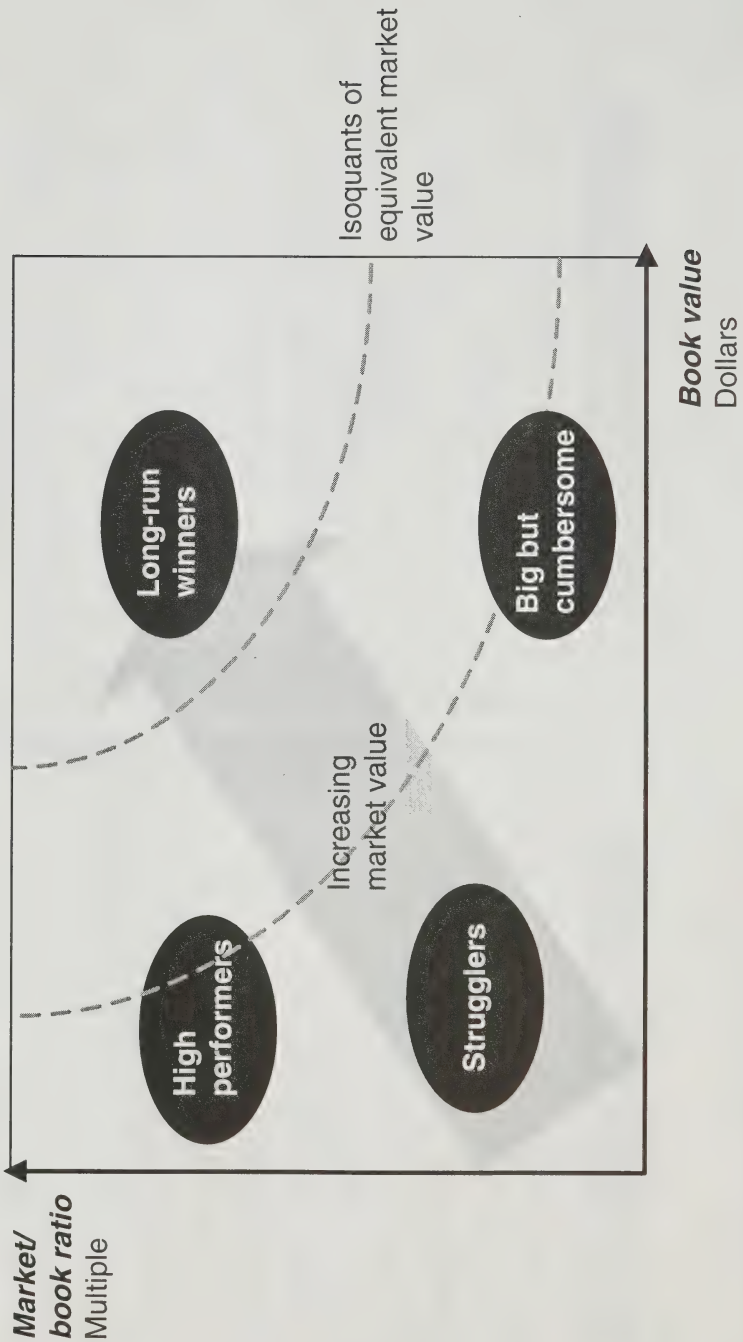
**LARGER PLAYERS, SUCH AS FIDELITY, CAN OFFER CONSUMERS
GREATER PRODUCT CHOICE AND EXPERTISE**

ESTIMATES

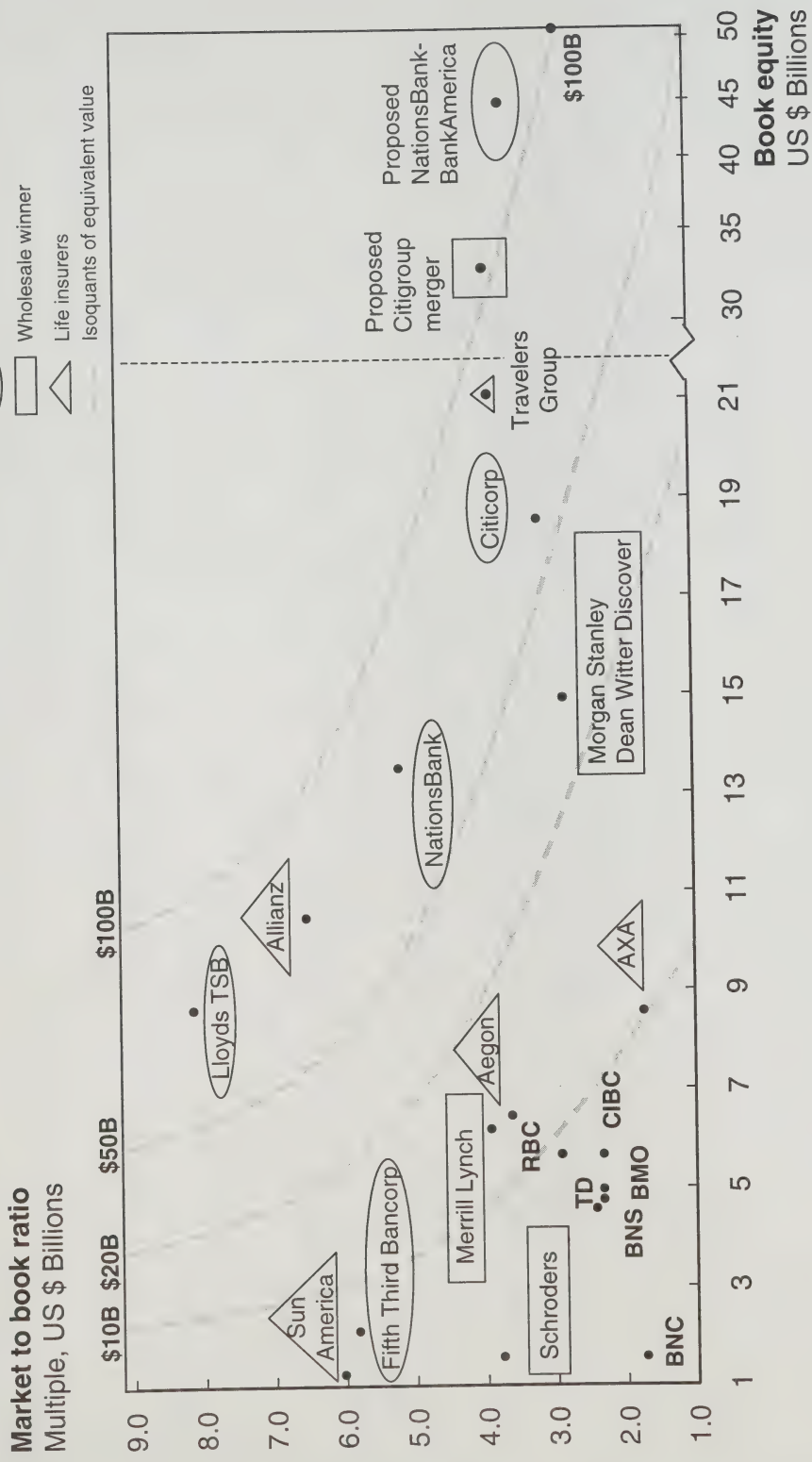


WINNERS HAVE EMERGED ACROSS THE FINANCIAL SERVICES LANDSCAPE

Defining characteristics



WINNERS HAVE EMERGED



* Market capitalization: December 1997, book equity for fiscal year-end 1996

FIVE BROAD STRATEGIES WIN IN PFS

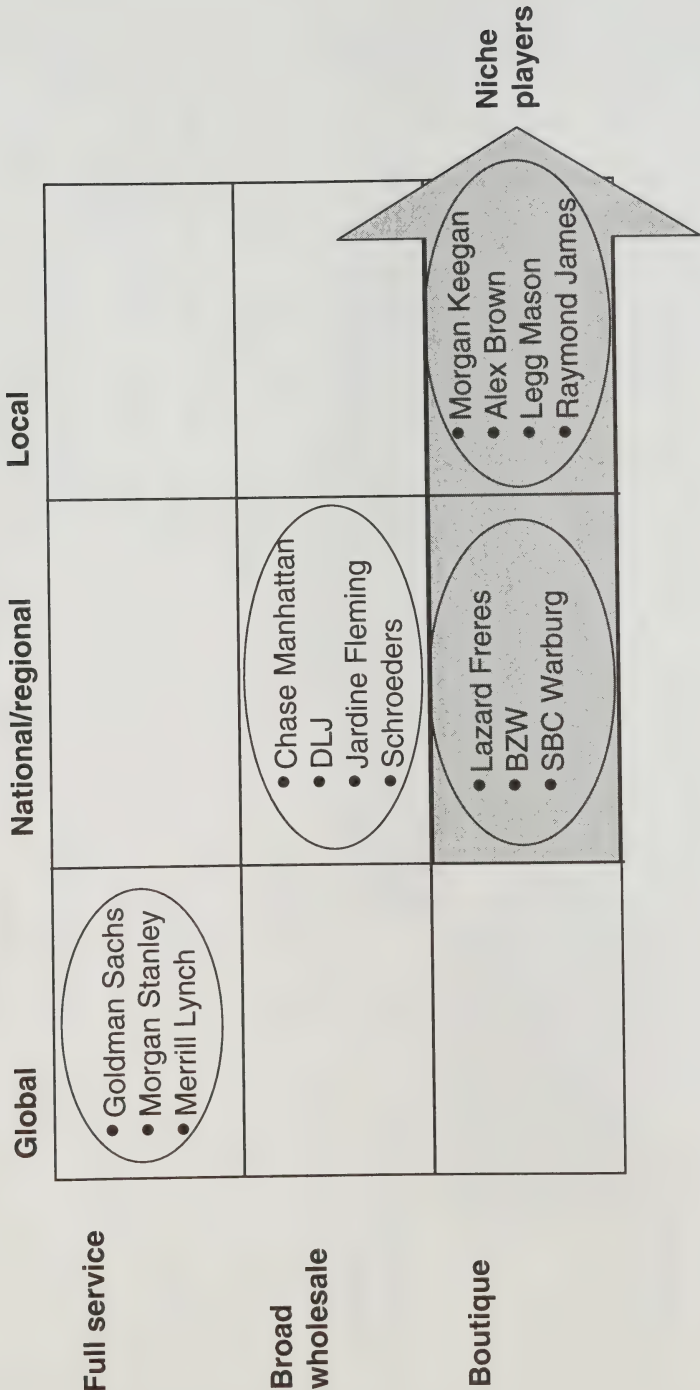
✓ Required
 ✕ Not
 required

Winning PFS strategy	Representative players	Dimensions of competitiveness				
		Operational excellence	Customer offer	Customer franchise	Product scope	International presence
1. <i>Global multi-line</i>	<ul style="list-style-type: none"> • Citibank 	✓	✓	✓	✓	✓
2. <i>National multi-line</i>	<ul style="list-style-type: none"> • Lloyds TSB 	✓	✓	✓	✕	✕
3. <i>Regional (i.e., inter-state) multi-line winner</i>	<ul style="list-style-type: none"> • Fifth Third • Wells Fargo • NationsBank 	✓	✓	✕	✓	✕
4. <i>Product-focused winner</i>	<ul style="list-style-type: none"> • Fidelity • MBNA 	✓	✓	✕	✕	✕
5. <i>Targeted community providers</i>	<ul style="list-style-type: none"> • Credit unions/caisses 	✓	✓	✕	✕	✕

Source: McKinsey & Company analysis

WINNERS IN WHOLESALE DELIBERATELY PICK COMPETITIVE ARENA

SELECT PLAYERS



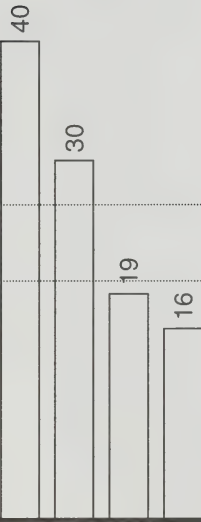
SELECT WHOLESALE PLAYERS ACHIEVE HIGH ANNUALIZED RETURNS

Annualized returns 1992-97

Percent

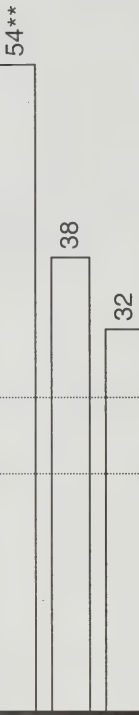
Global players

Merrill Lynch
Morgan Stanley Dean
Witter Discover
Salomon Brothers
JP Morgan



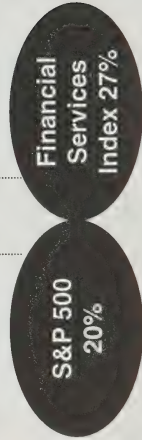
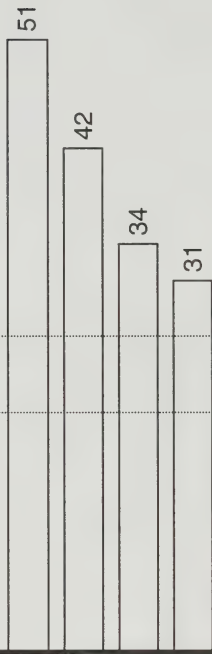
National/regional players

DLJ
Schroeders
Bear Stearns



Niche

Alex Brown
Morgan Keegan
Raymond James
Legg Mason

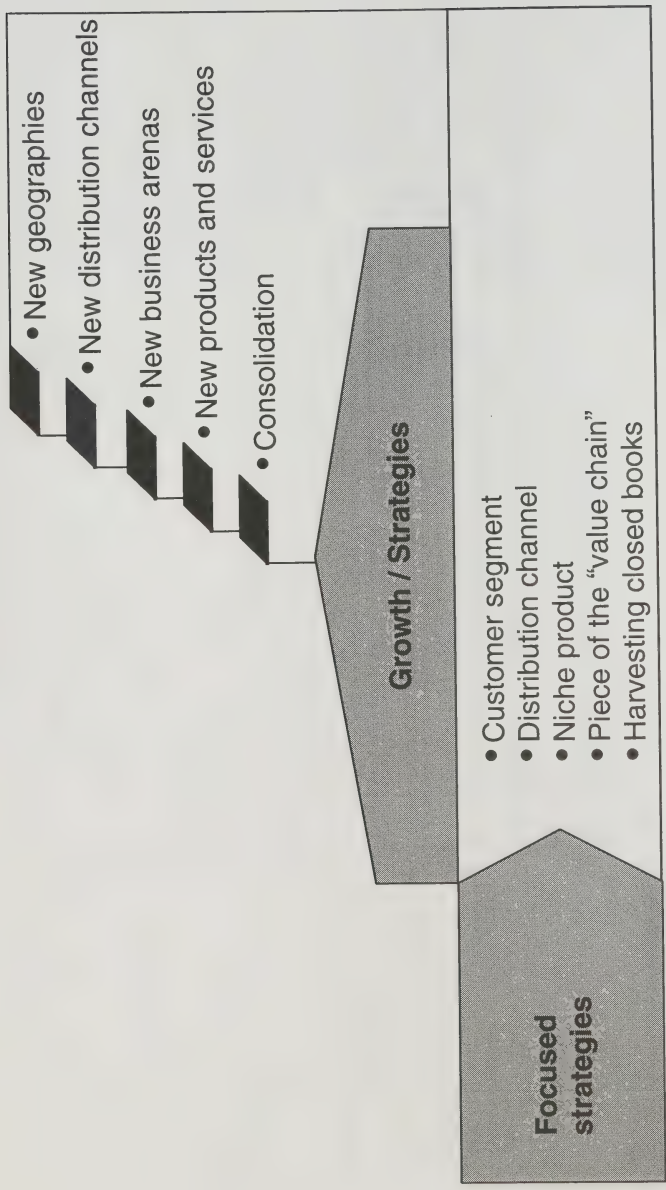


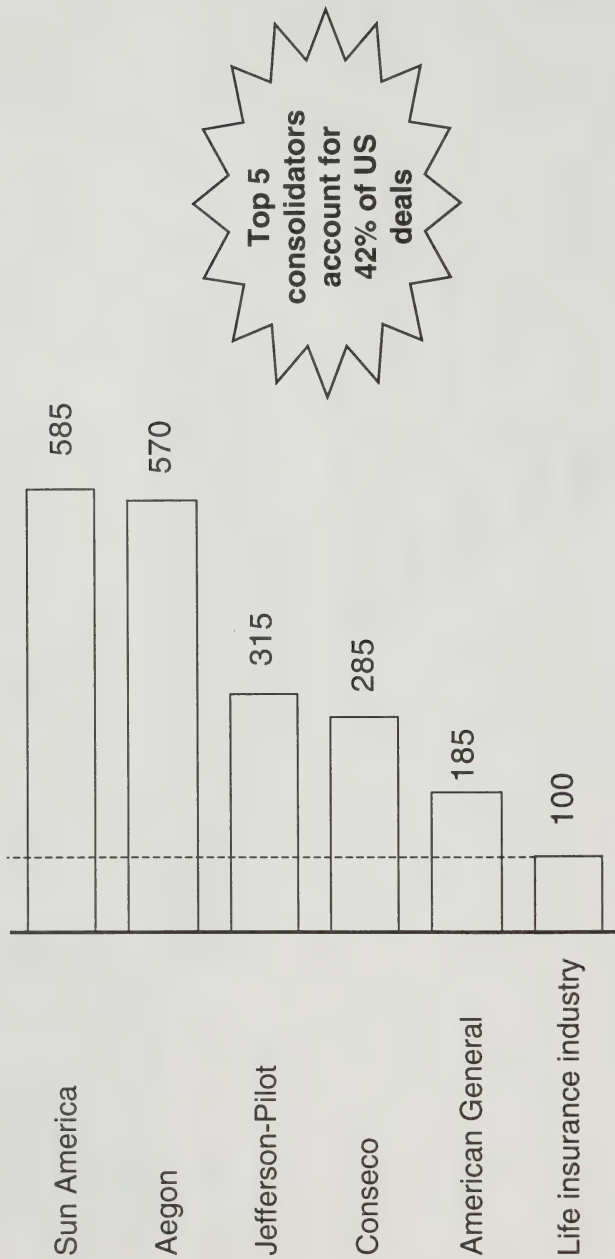
* Total income appreciation; assuming dividends reinvested

** Annualized return from November 1995 to December 1997

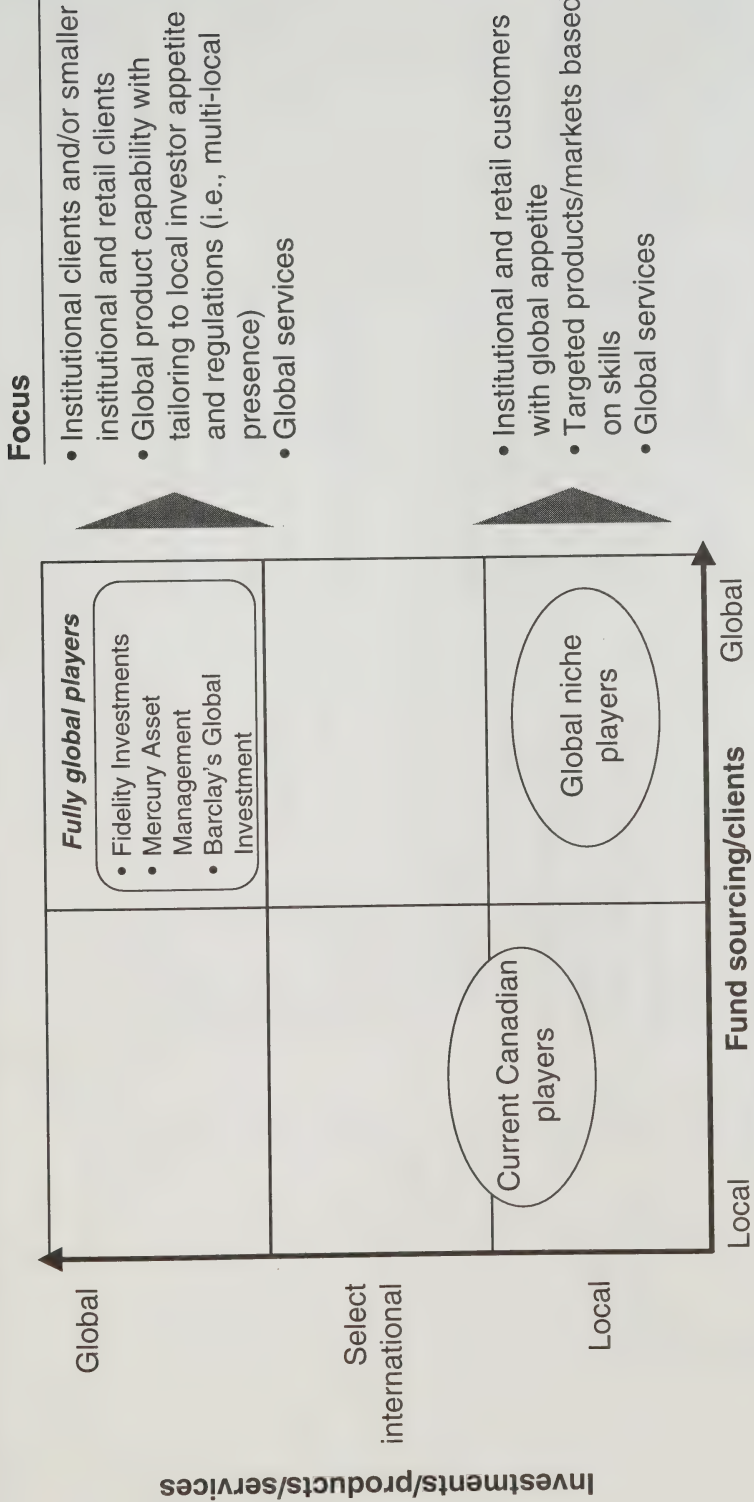
Source: Compustat; Global Vantage

LIFE INSURANCE WINNERS PURSUE ONE OF TWO POTENTIALLY REINFORCING PATHS



PROFITABLE US LIFE CONSOLIDATORS HAVE RAPIDLY ADDED VALUEUS EXAMPLE**Index of total shareholder return 1993-96**

WINNERS IN GLOBAL ASSET MANAGEMENT HAVE GLOBAL CAPABILITIES

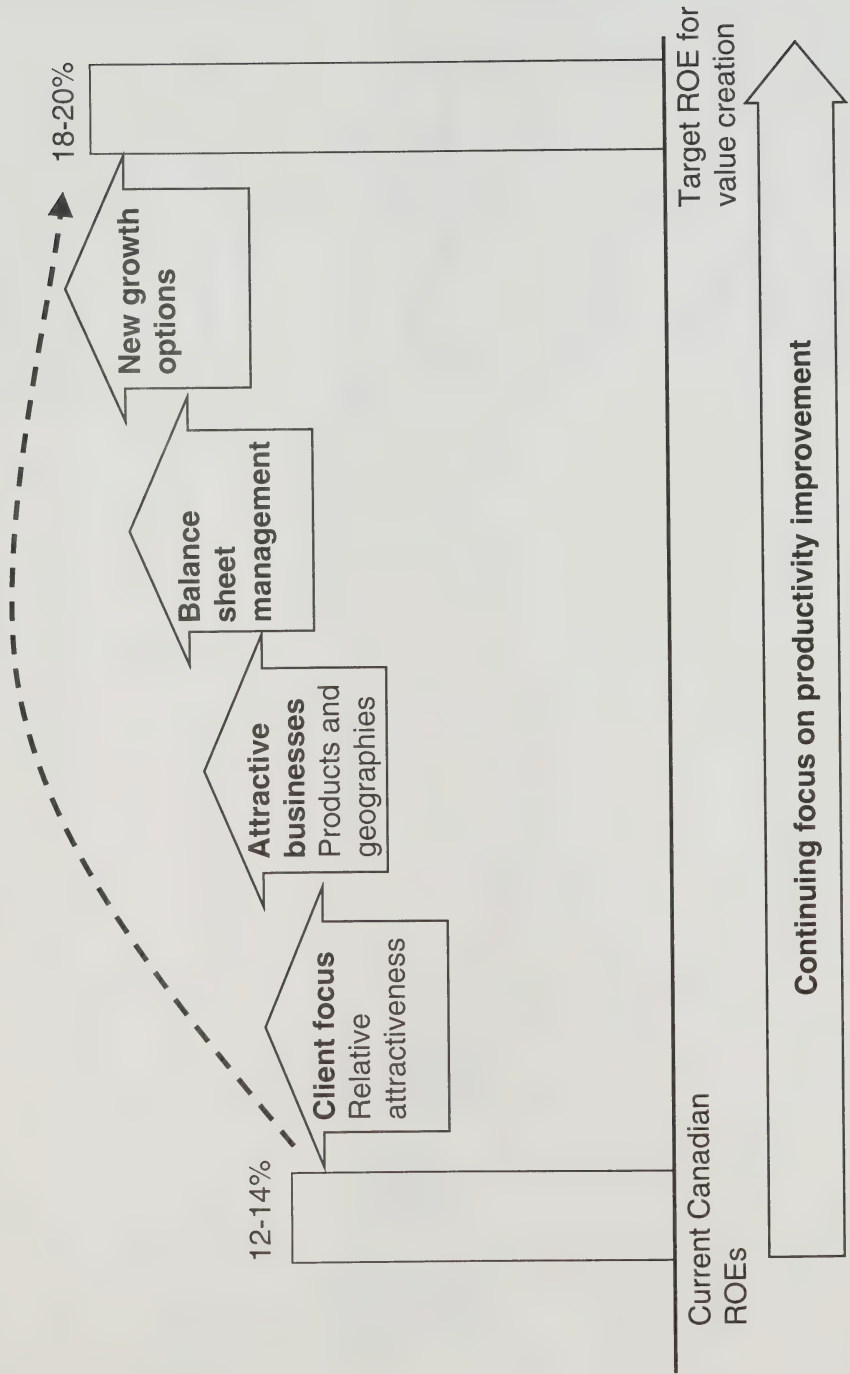


- Largely domestic clients
- Largely domestic product offer with select (and narrow) international capabilities
- Domestic services

VIEW OF STARTING POSITION UNDERPINS CHOICE OF STRATEGY

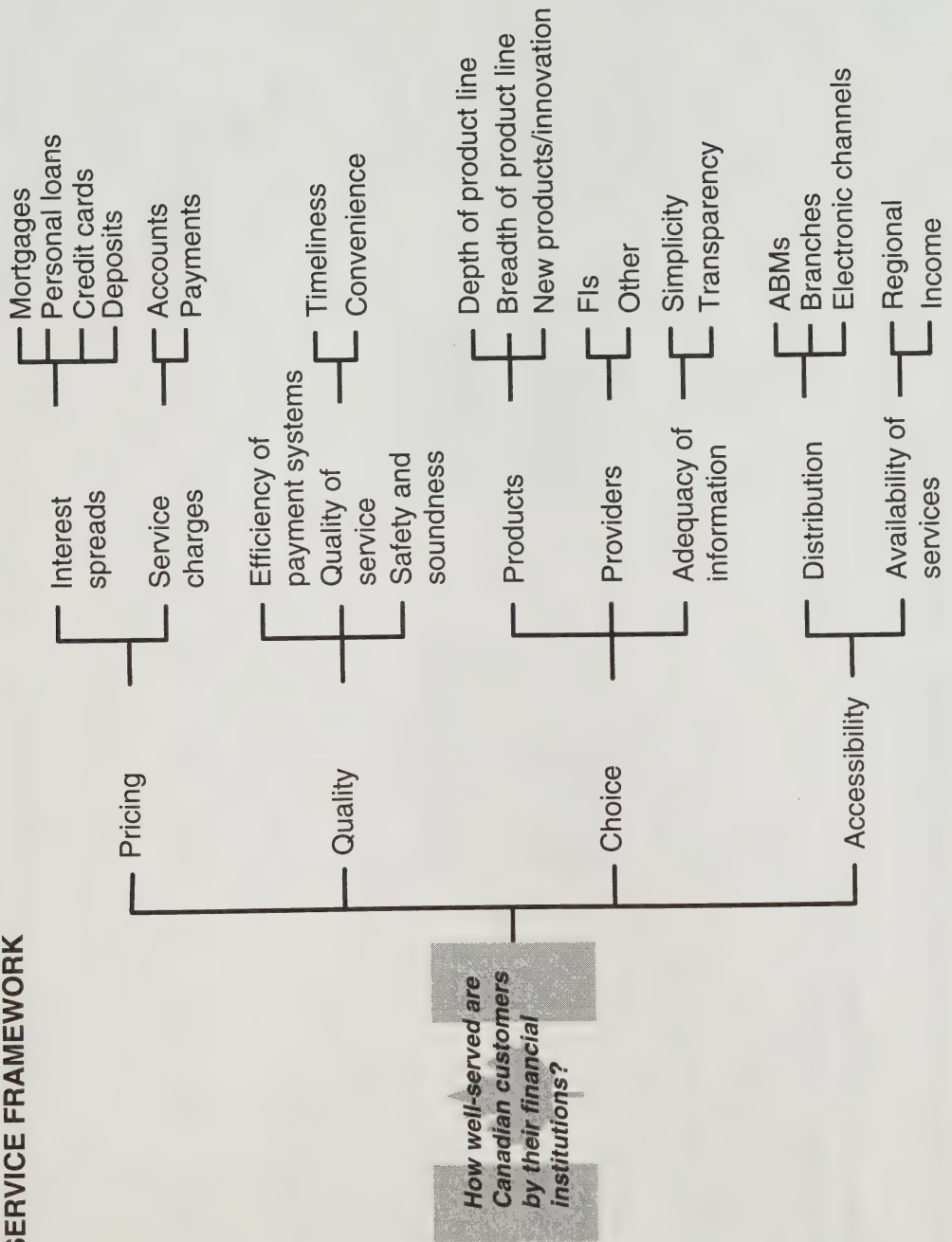


WHOLESALE STRATEGIES DEMAND A NUMBER OF COMPONENTS TO DRIVE UP RETURNS



Chapter 6 Exhibits

A SERVICE FRAMEWORK

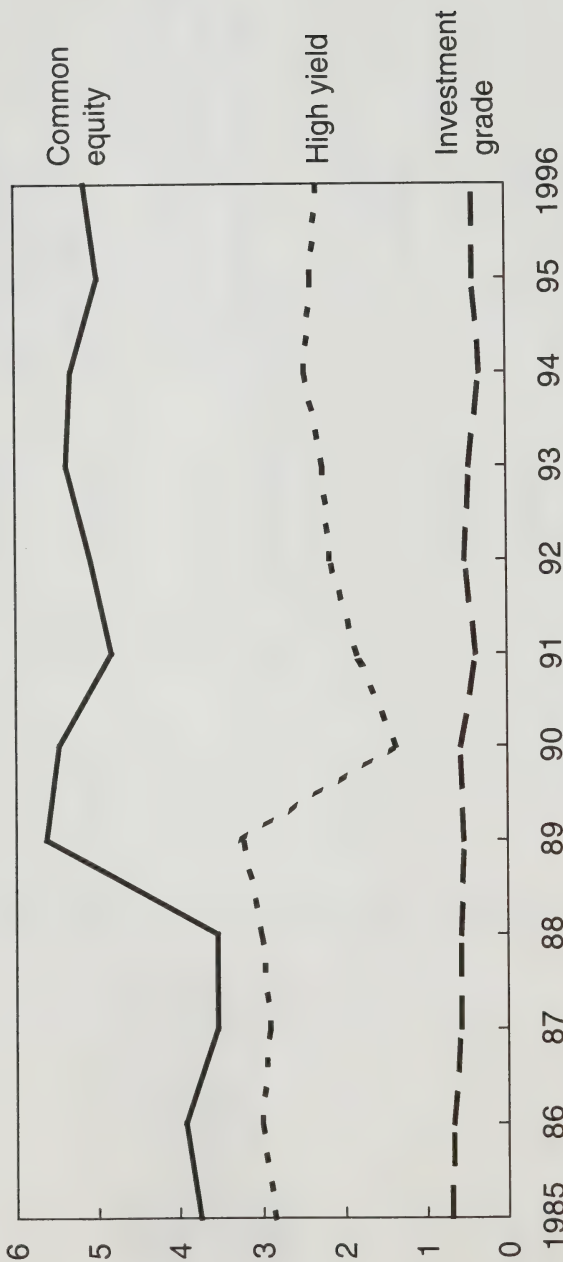


DEBT SPREADS HAVE DECLINED OVER THE PAST 10 YEARS

US EXAMPLE

Underwriting spreads
Percentage of principal

1985-96
CAGR %

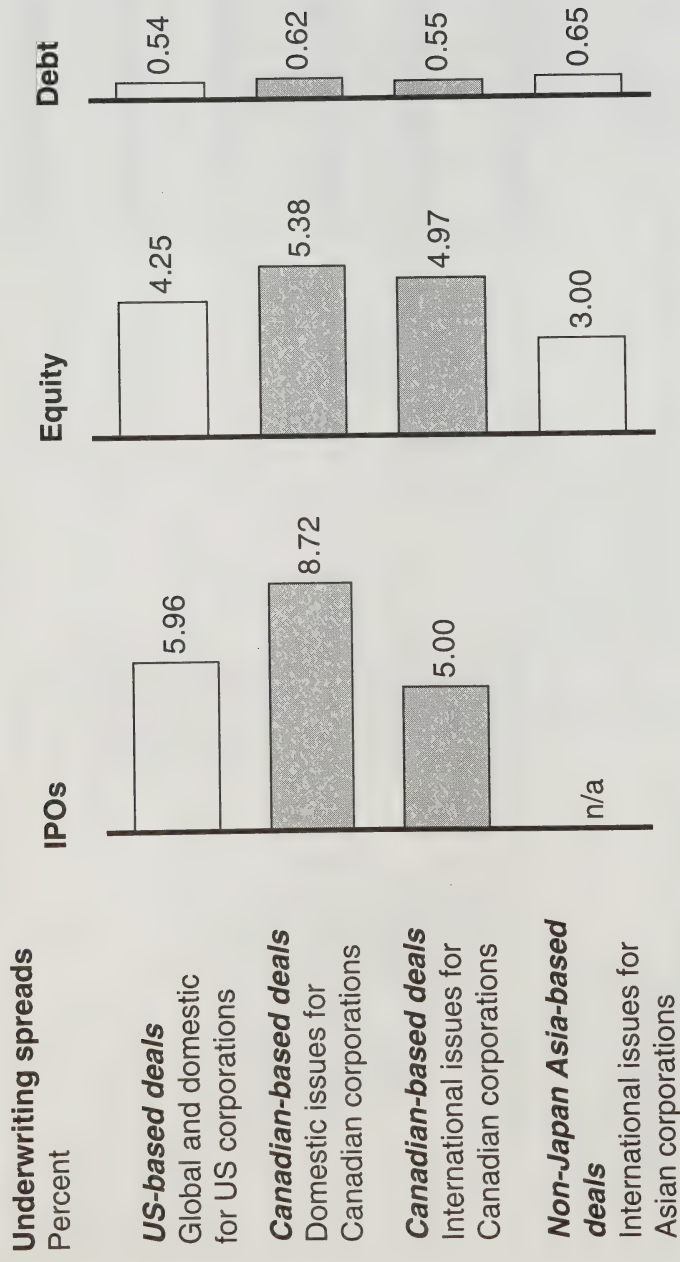


Common equity

High yield

Investment grade

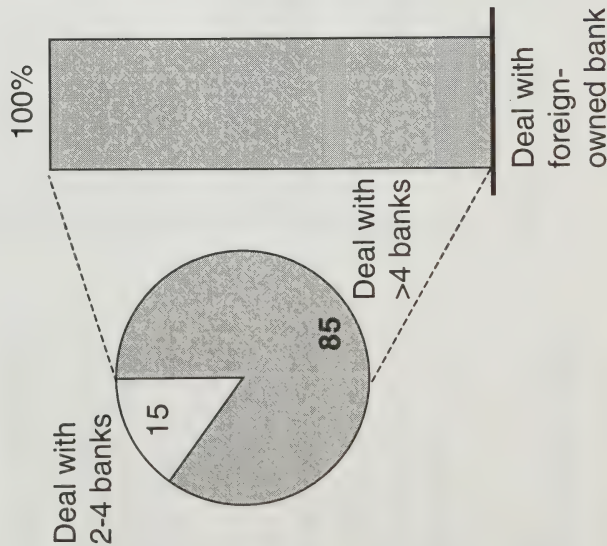
CANADIAN AND US SPREADS ARE SIMILAR



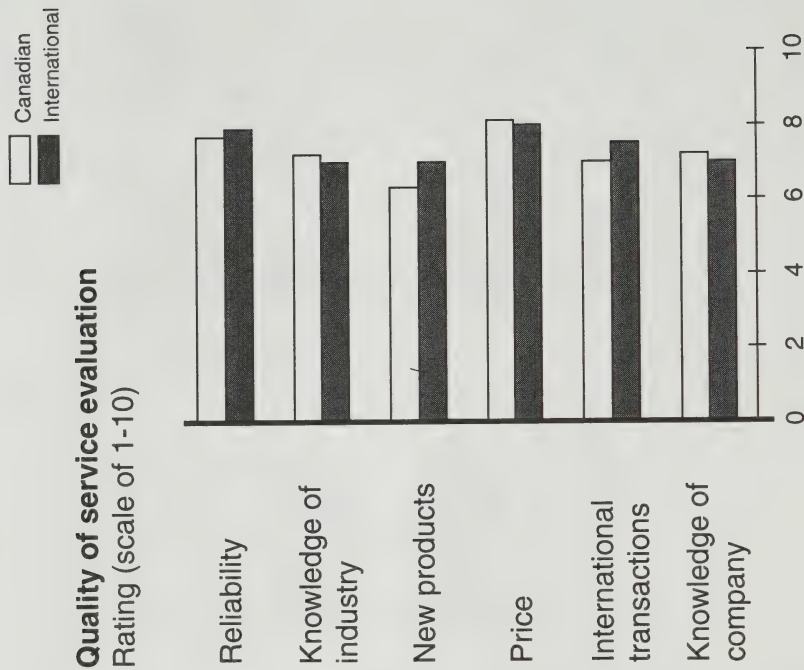
Source: The Financial Post database; Investment Dealers' Digest

LARGE CORPORATIONS HAVE MULTIPLE BANKING RELATIONSHIPS

Larger corporate banking relationships
Percent



Quality of service evaluation
Rating (scale of 1-10)

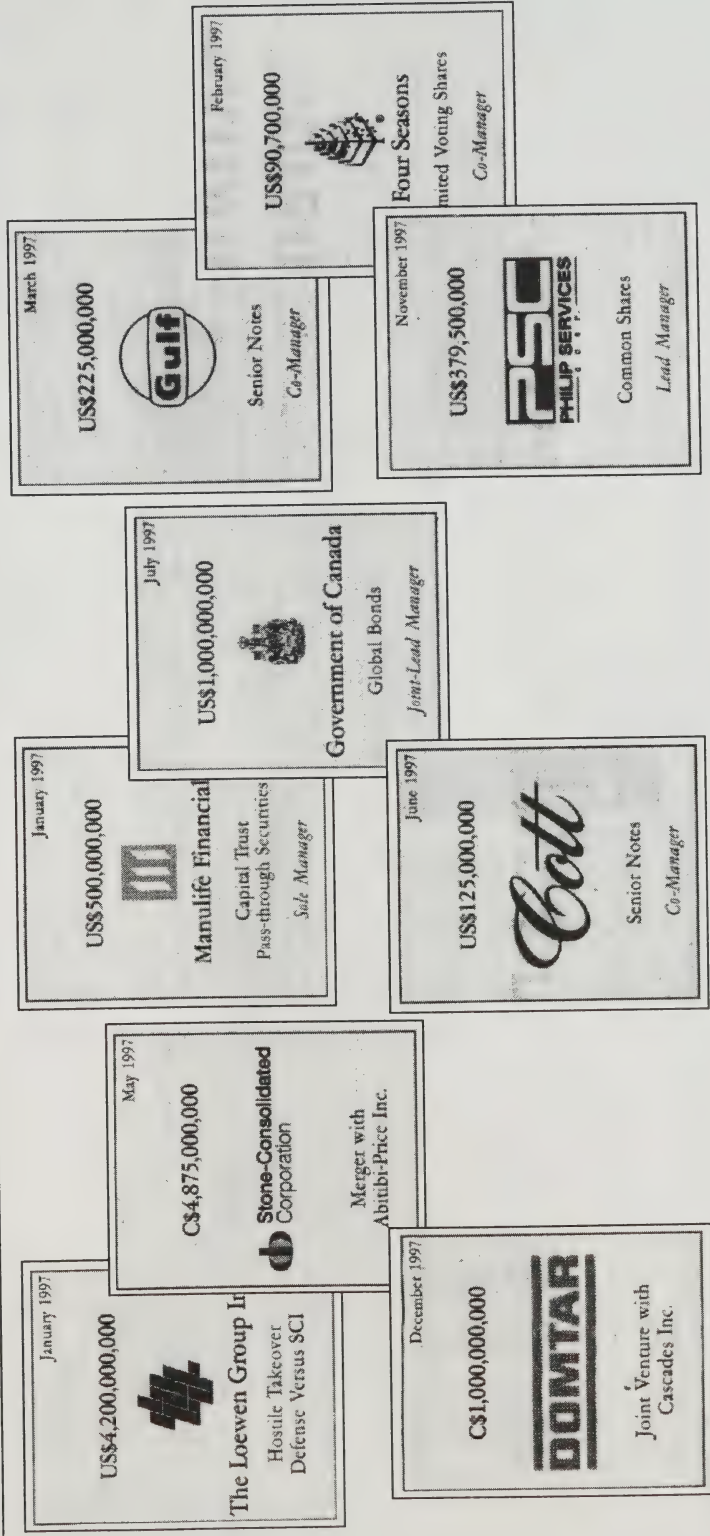


SALOMON SMITH BARNEY IS ACTIVE IN CANADIAN MARKET

Equity

Debt

Advisory



LARGE CANADIAN DEALS ARE NOT GOING TO CANADIAN INVESTMENT BANKS

Top 10 advisors on all international deals 1997

1. Morgan Stanley
2. Goldman Sachs
3. JP Morgan
4. CSFB
5. SBC Warburg DR
6. Lazard
7. Deutsche MG
8. UBS
9. Merrill Lynch
10. Rothschild

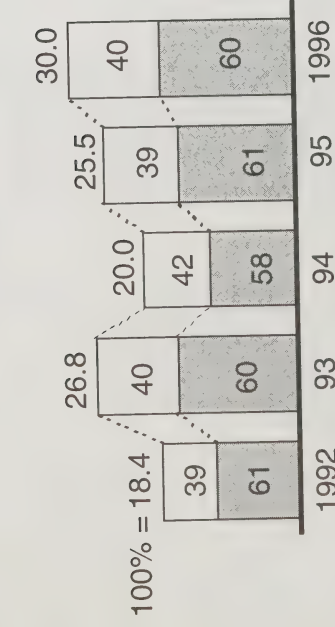
Canadian cross-border billion dollar deals 1997

<i>Buyer</i>	<i>Target</i>	<i>Value</i> US \$ Millions	<i>Advisor</i>
Newcourt Credit	AT&T Capital Group	1,690	• Morgan Stanley
Canadian Occidental	Wascana Energy	1,382	• Goldman Sachs
Laidlaw	American Medical Response	1,200	• Merrill Lynch
Cable & Wireless	Bell Cablemedia/ Videotron/Nynex Cable	7,500	• Salomon Brothers • CSFB • Natwest Markets • Goldman Sachs • SBC Warburg DR

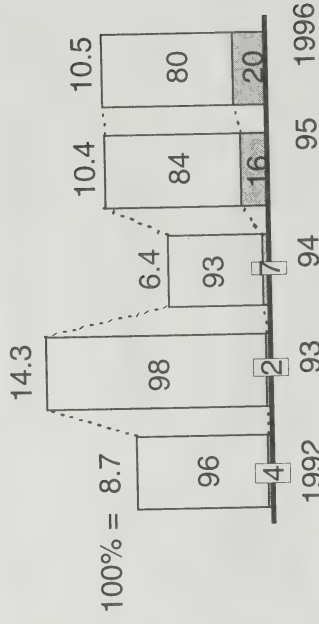
CANADIAN NEW ISSUES ARE SKEWED TO THE INTERNATIONAL MARKET

Canadian issues in
 Canada
 International

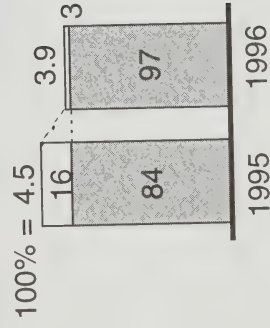
Canadian corporate issues
 \$ Billions, percent



Canadian new issues – equity
 \$ Billions, percent



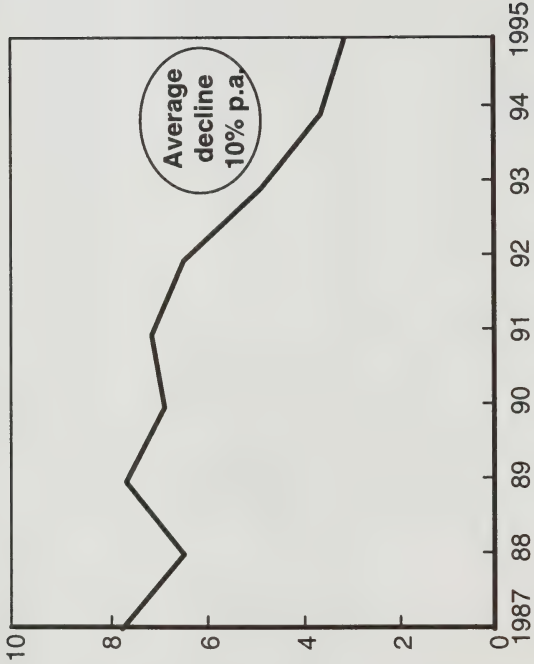
Canadian high-yield issues
 \$ Billions, percent



COMMISSIONS FOR INSTITUTIONAL INVESTORS ARE DECLINING

ESTIMATE

Commission paid* 1987-1995
Cents per share

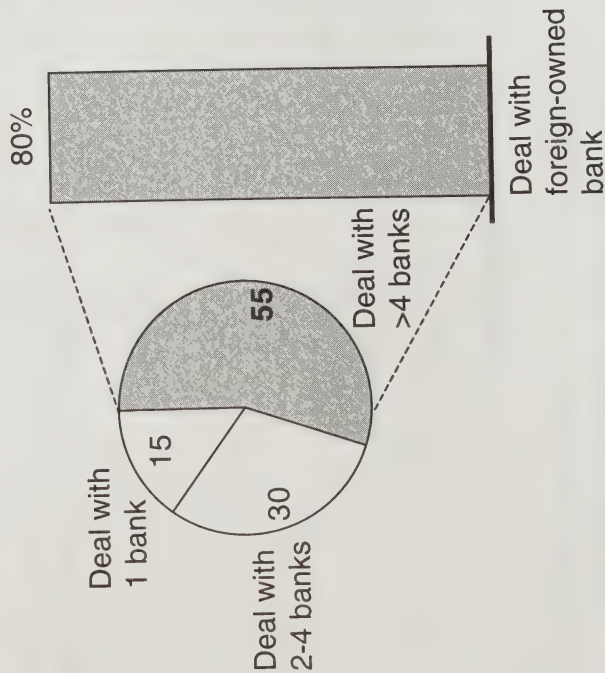


* Average brokerage commissions paid by institutions with total commissions greater than US \$5 million
Source: SIA; NYSE Fact Book; FIBV; Guide to World Equity Markets; Institutional Investor; McKinsey analysis

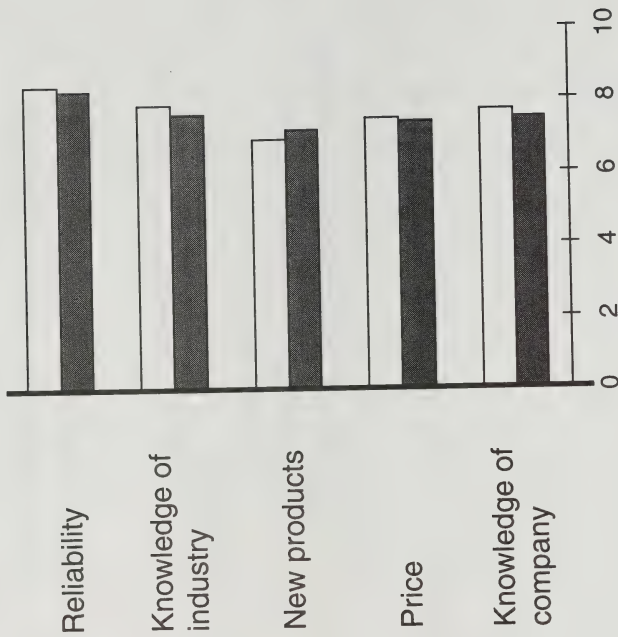
COMMERCIAL MID-MARKET CORPORATIONS HAVE MULTIPLE BANKING RELATIONSHIPS

Canadian
 International

Mid-market banking relationships
Percent

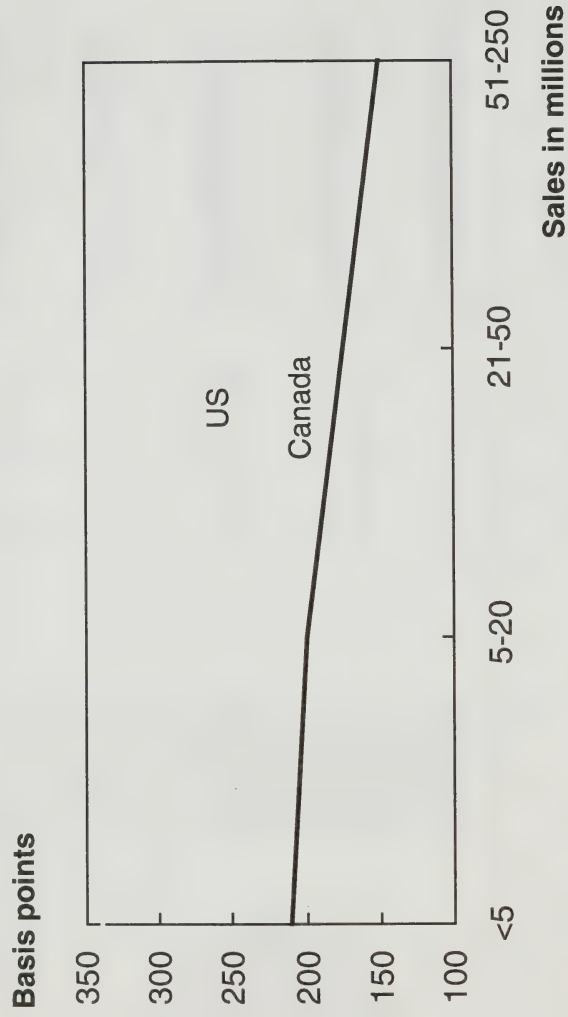


Quality of service evaluation
Rating (scale of 1-10)



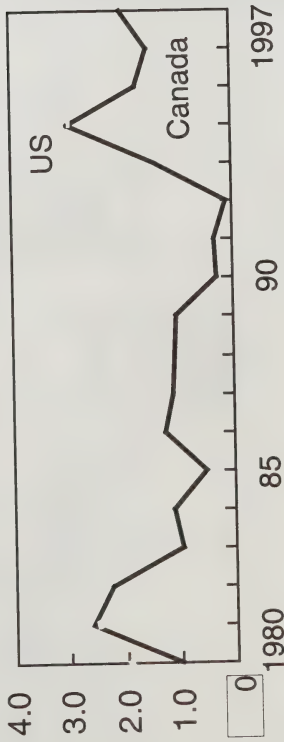
SPREADS ARE LOWER IN CANADA THAN IN THE US

Pricing comparison by size of borrower
Spread over cost of funds August 1996

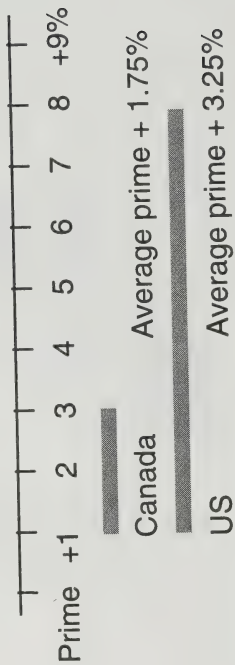


CANADIAN SPREADS ARE LOWER

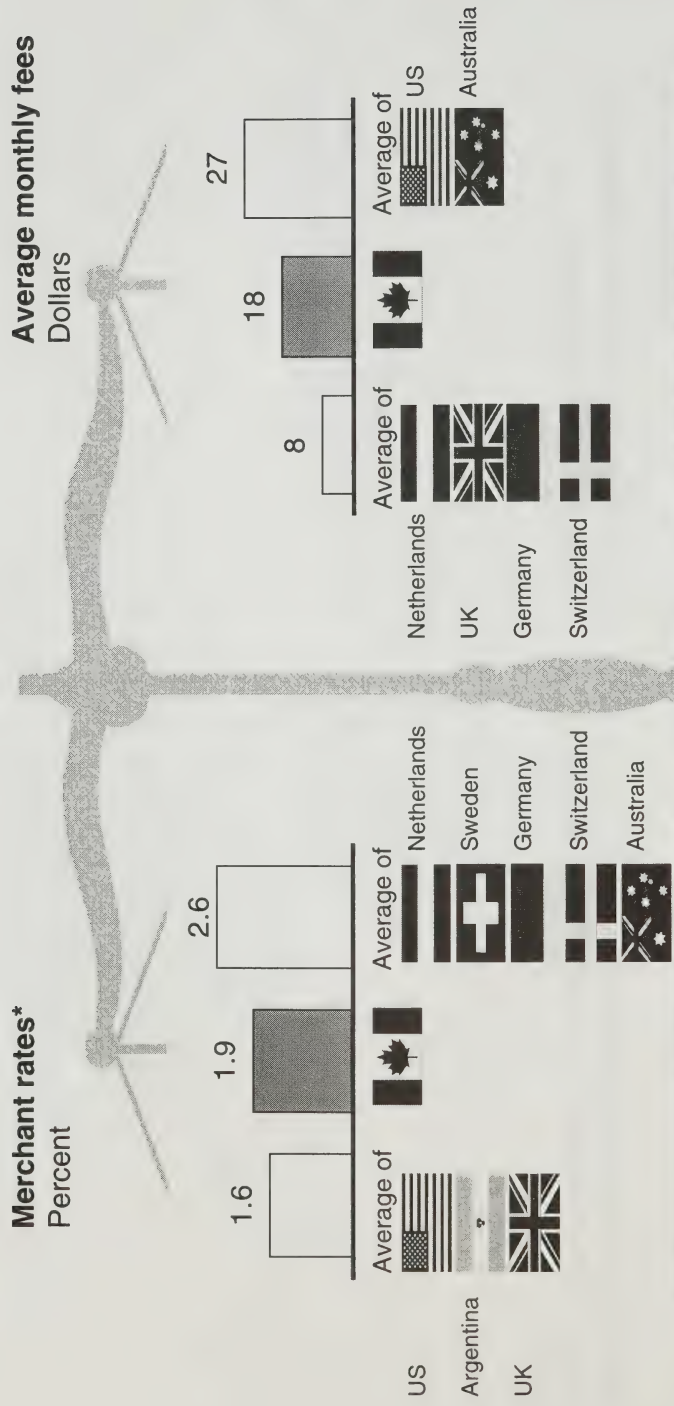
Lower spread between prime and Bank of Canada than prime and US Federal Reserve
Percent



Significantly narrower range of interest rates in Canada



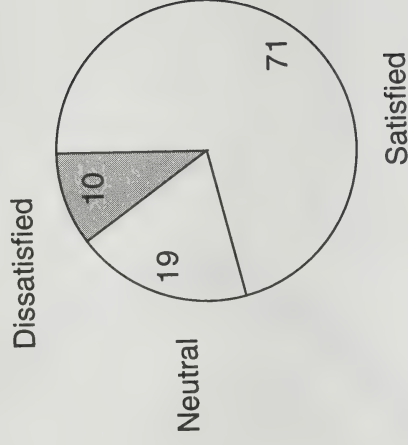
CANADA IS IN THE MIDDLE



* Merchant discount rate is the percentage of the value of transactions that merchants pay to credit card companies

SERVICE QUALITY GAPS EXIST BUT SMEs REMAIN LOYAL TO PRIMARY INSTITUTION

Overall service quality good
Percentage satisfied and dissatisfied



SME loyalty

>10-year
tenure with
main institution

Relationship continuity

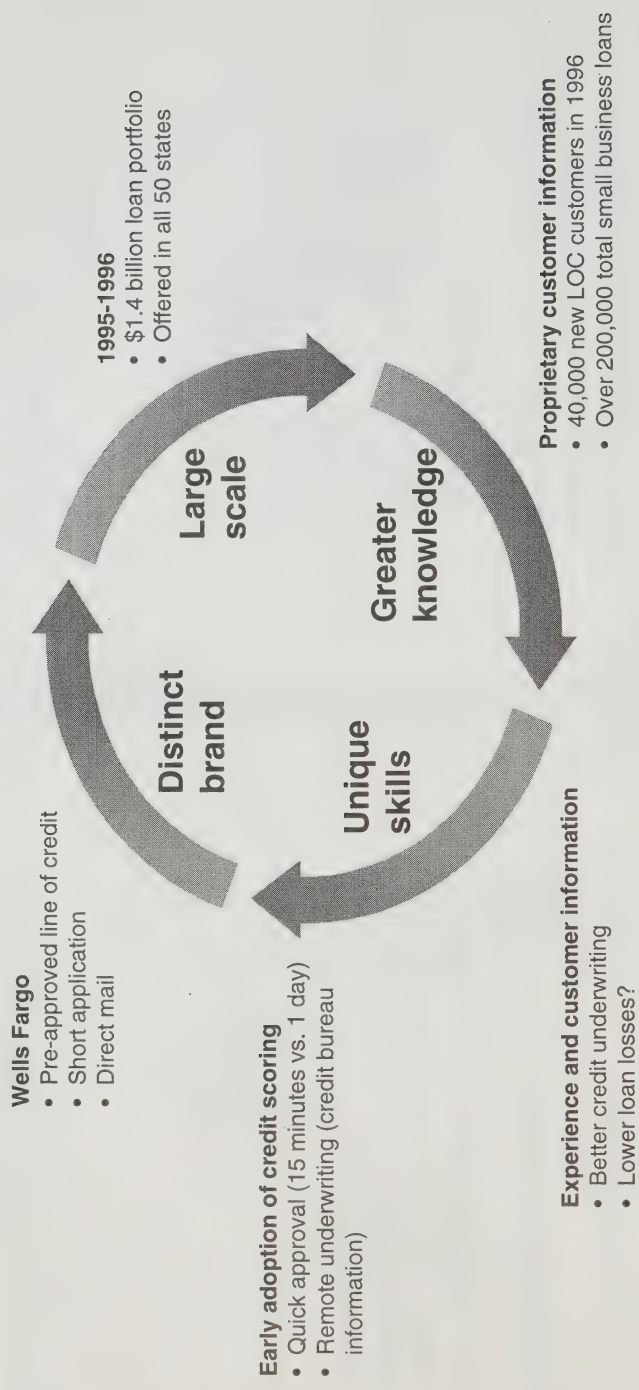
- Complaints about account manager turnover – 60% of respondents reported more than 1 account manager in 3 years

Responsiveness

- Complaints about turnaround time for loans and bureaucratic credit approval procedures

WELLS FARGO HAS BECOME A CATEGORY KILLER

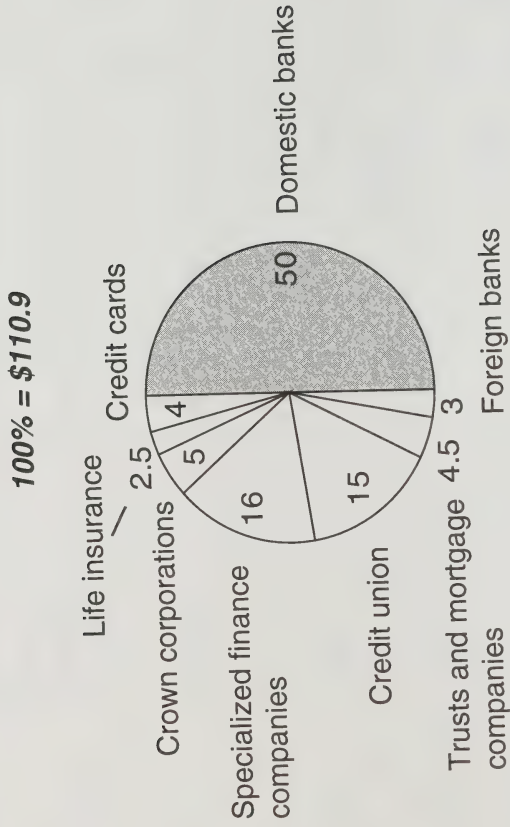
Winning formula for category killers – the Wells Fargo story



OTHER SOURCES ARE AVAILABLE BUT BANKS DOMINATE SME MARKET

SME business debt financing

Cdn \$ Billions, percent



LOAN AMOUNTS ARE INCREASING OVERALL BUT DECREASING FOR SMALLEST BORROWERS

Amount outstanding for borrowings <\$1 million*

Cdn \$ Billions, percent

Loan value Cdn \$ Thousands	100% =				1995-97 CAGR	
	1995	1996	Sept. 30/97			
500-1,000	26.3	25.8	26.2	46.5	3.7	
250-500	24.9	25.2	25.2		3.6	
100-250	27.6	27.8	27.6		4.3	
50-100	11.8	12.1	11.9		3.6	
25-50	5.5	5.6	5.6		4.4	
1-25	3.9	3.4	3.5		4.2	
					-1.1	

* Chartered banks

Source: CBA

SME CREDIT HAS GROWN FASTER IN THE US

Outstanding commercial loans at US commercial banks for borrowings <\$1 million
US \$ Billions, percent





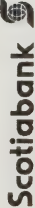

Loan value US \$ Thousands	100% = 191.3	1-year growth Percent
250-1,000	40	9.33
100-250	19	9.04
<100	41	9.43
June 1997		

Cdn amount outstanding for borrowings <\$1 million
Cdn \$ Billions, percent

Loan value Cdn \$ Thousands	100% = 46.4	1-year growth Percent
250-1,000	51	3.8
100-250	28	1.7
<100	21	-0.5
June 1997		

FINANCIAL INSTITUTIONS ARE MOVING AGGRESSIVELY TO SERVE SMES BETTER

NOT EXHAUSTIVE

Institution	Program
	<ul style="list-style-type: none"> • First Bank Plan – \$50,000 unsecured credit with 24-hour turnaround and 1-page application
	<ul style="list-style-type: none"> • Job creation loan fund – \$15,000-100,000 loans at prime less 1% with no fees
	<ul style="list-style-type: none"> • 13 specialized knowledge-based industry banking centres • Advanced Technology Loan Program
	<ul style="list-style-type: none"> • KBI specialists • Small Business Venture Fund
	<ul style="list-style-type: none"> • \$50 million Loan Program for Innovation and Growth Sector
	<ul style="list-style-type: none"> • Export program partnership between National Bank and Société de Développement Industriel du Québec

WELLS FARGO IS TESTING THE CANADIAN MARKET

WELLS FARGO

Small Business Banking

HOME NEW

CANADIAN SMALL BUSINESS

Thank you for your interest in Wells Fargo Business Credit line of credit for Canadian small businesses. Wells Fargo Bank continues to have interest in offering our business line of credit product in Canada. Unfortunately, we regret that we are unable to extend credit to you at this time since the program is only in the first phase with a limited number of Canadian small businesses.

If you would like, please send us the following information and we will be happy to contact you when we have a full launch of our program in Canada.

Your Full Name

Your Business Name

Your Business Street Address

Your Business City, Province

Your Business Postal Code

Your Business Phone Number

Your Business E-mail

Service attributes

- Short application
- Quick approval
- Reduced collateral requirements

Market share in

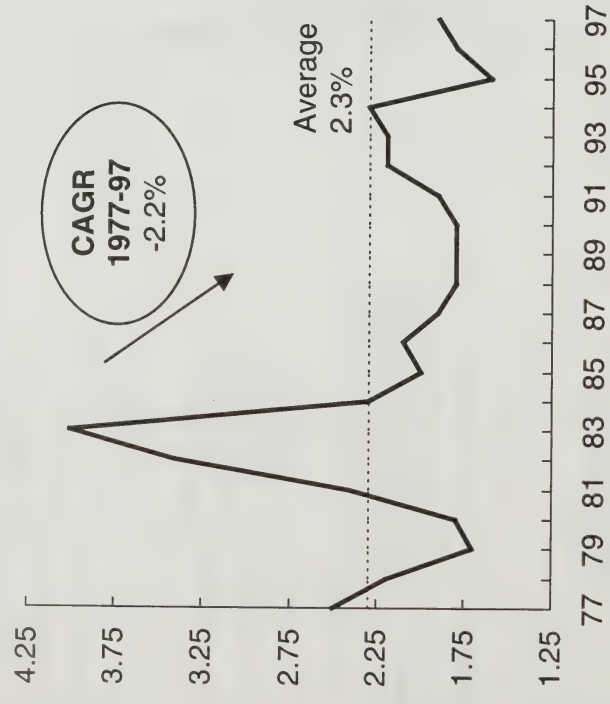
US

1993-96 CAGR =

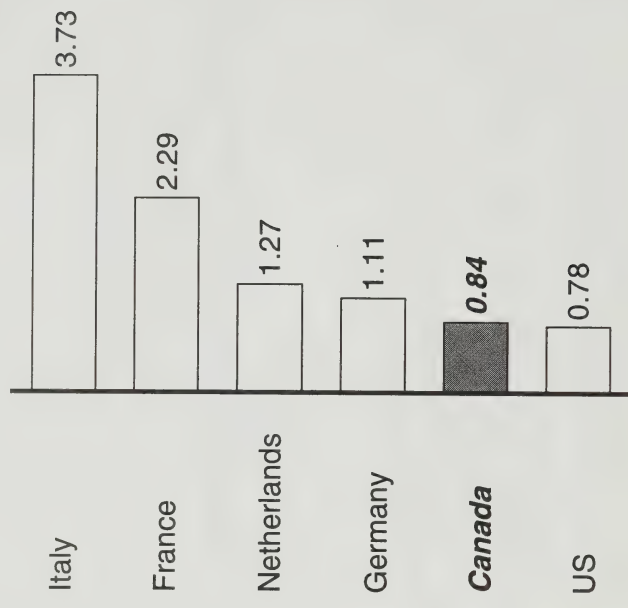
45%

CANADIANS BENEFIT FROM COMPETITIVE SPREADS

5-year mortgage spreads have declined over the past 20 years
Percent

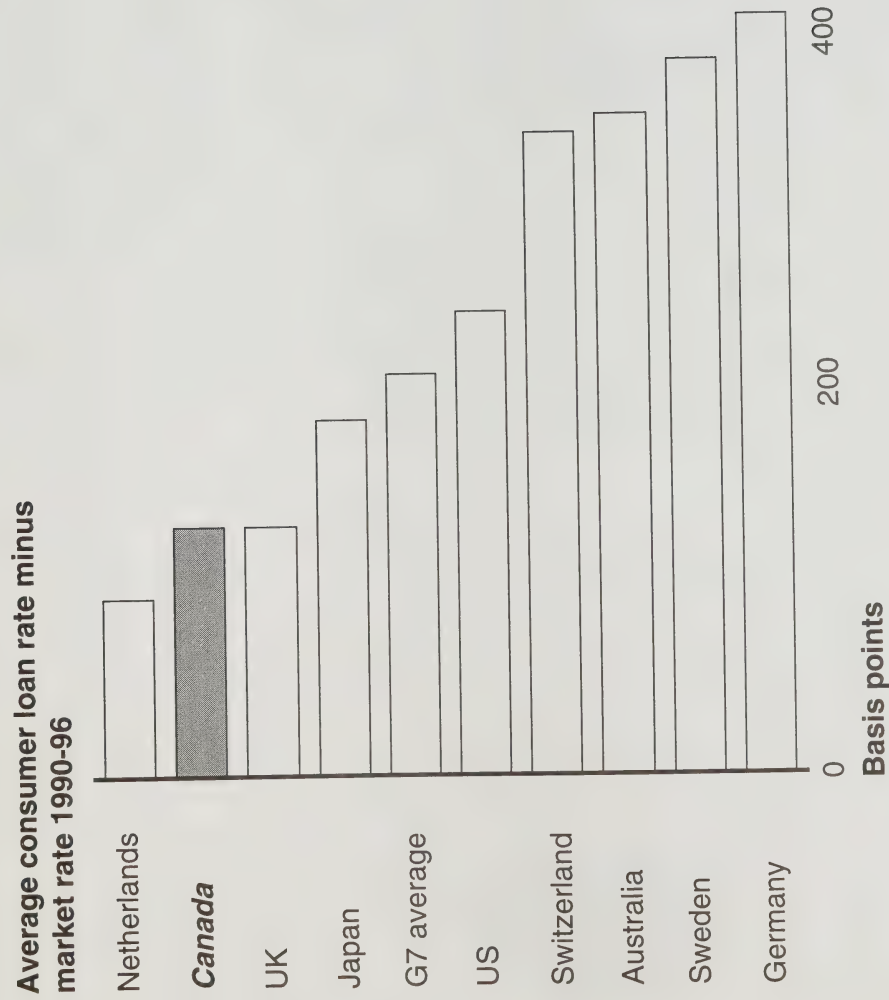


On average, 1-year mortgage* spreads are lower in Canada than in Europe
Percent

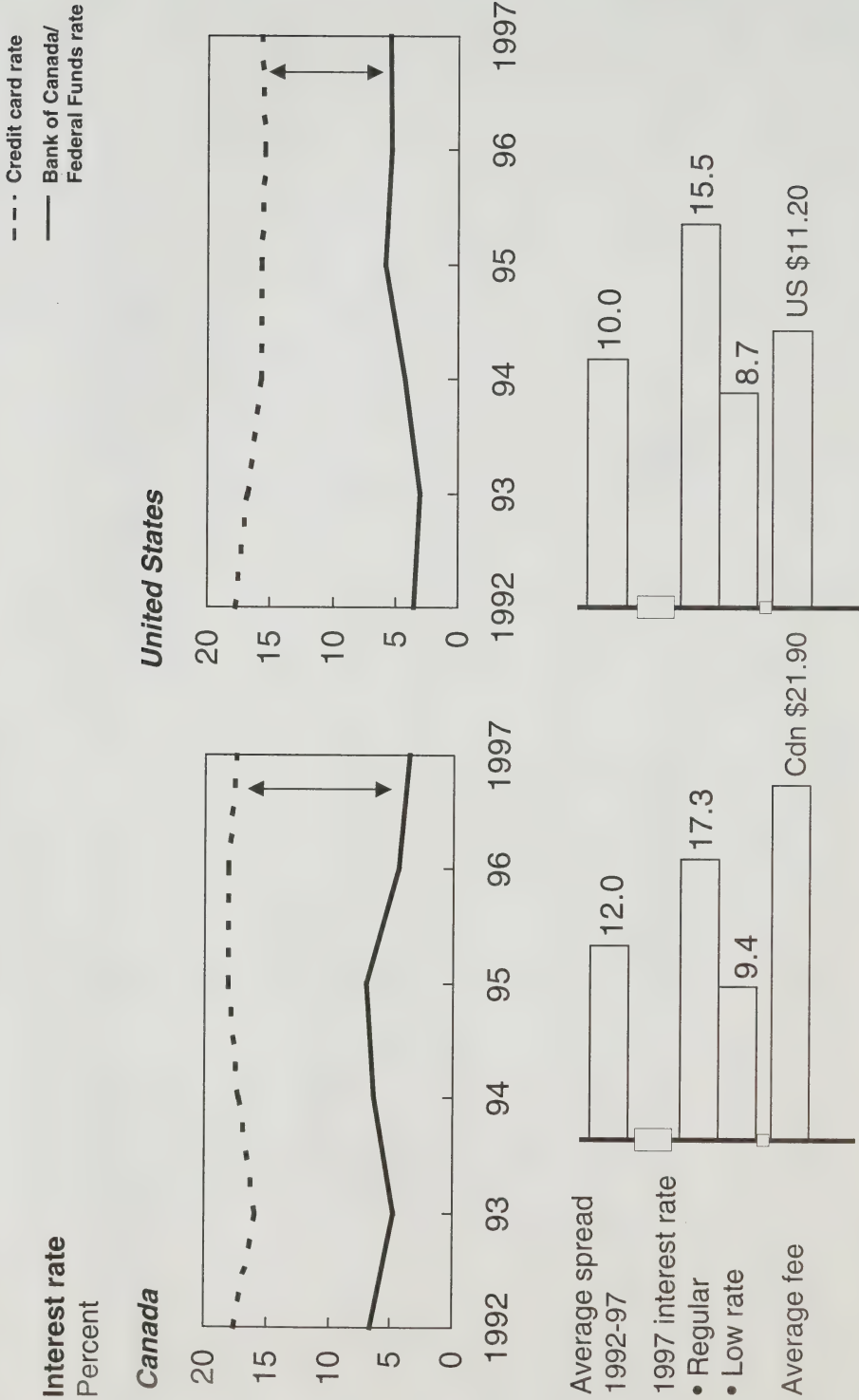


* Or equivalent

Source: Bank of Canada; McKinsey & Company analysis

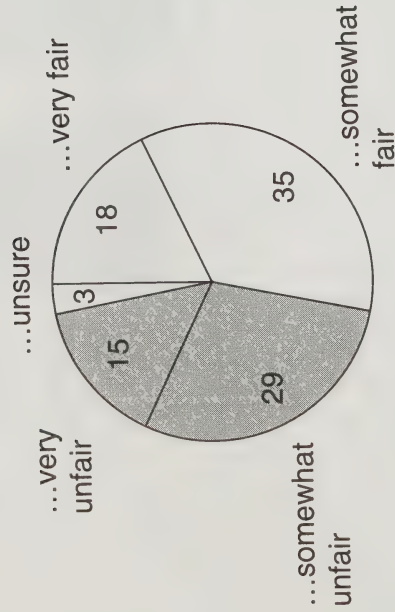
CANADA HAS COMPARATIVELY LOWER INTEREST RATE SPREADS ON PERSONAL LOANS

CREDIT CARD SPREADS ARE HIGHER IN CANADA

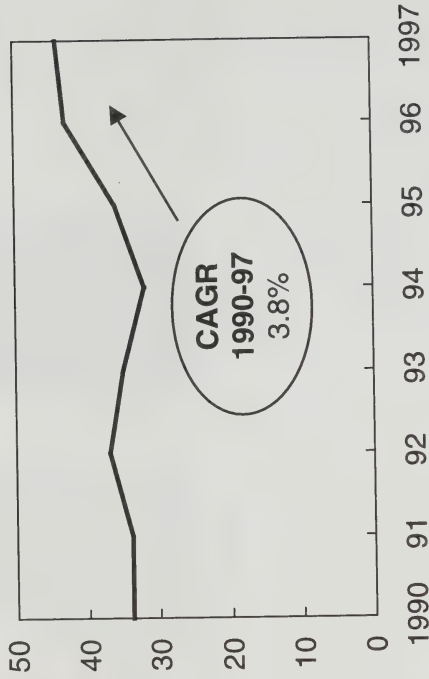


LESS THAN HALF OF RESPONDENTS VIEWED SERVICE CHARGES AS UNFAIR

Are financial institution service charges...
Percentage of respondents



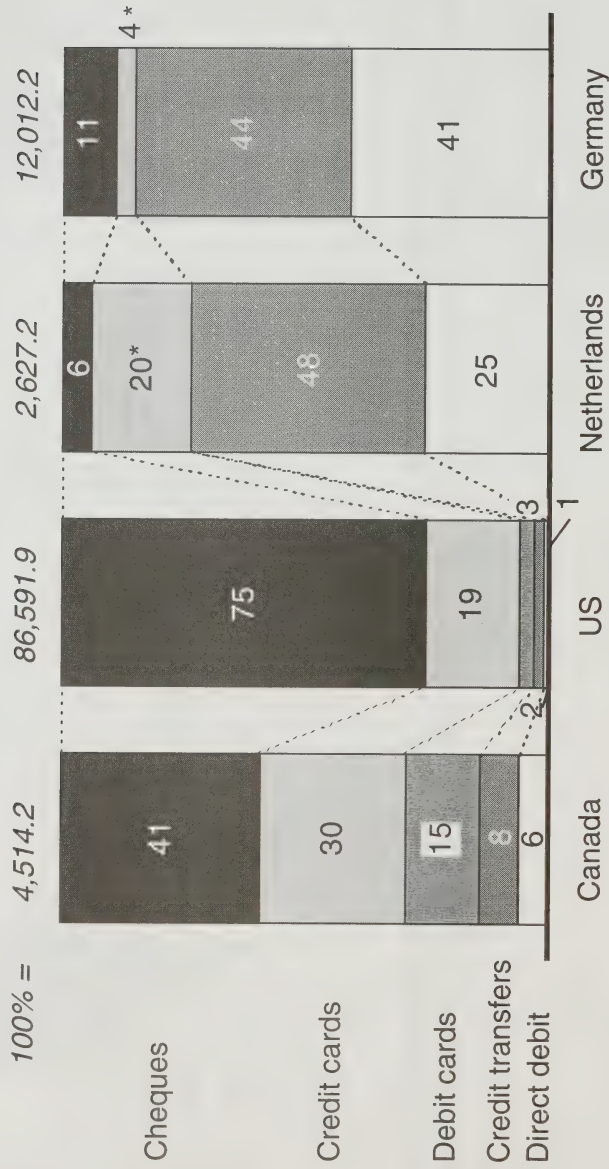
Change in % of respondents answering "somewhat or very unfair"



COMPARISON DIFFICULTY ARISES FROM DIFFERENT PAYMENT STRUCTURES

Payment instruments 1996

Millions of transactions, percent



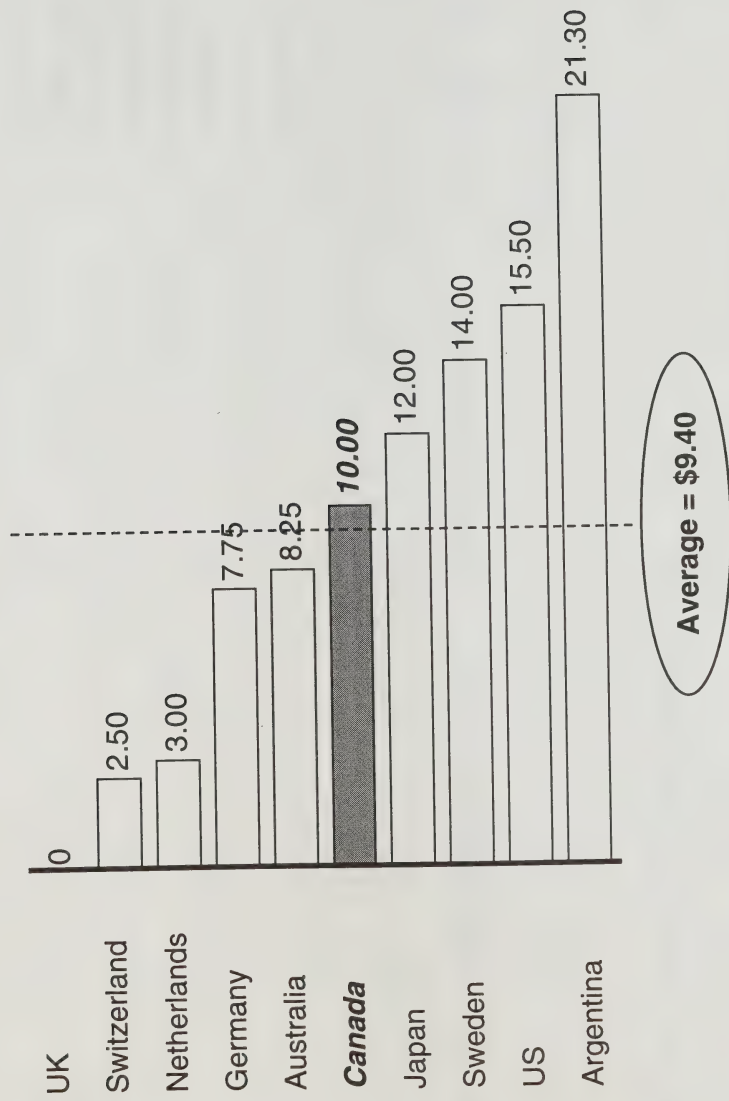
* Credit and debit cards

Source: BIS; McKinsey & Company analysis

WIDE VARIATIONS EXIST AMONG AVERAGE MONTHLY FEES

Average monthly fee*

Cdn \$

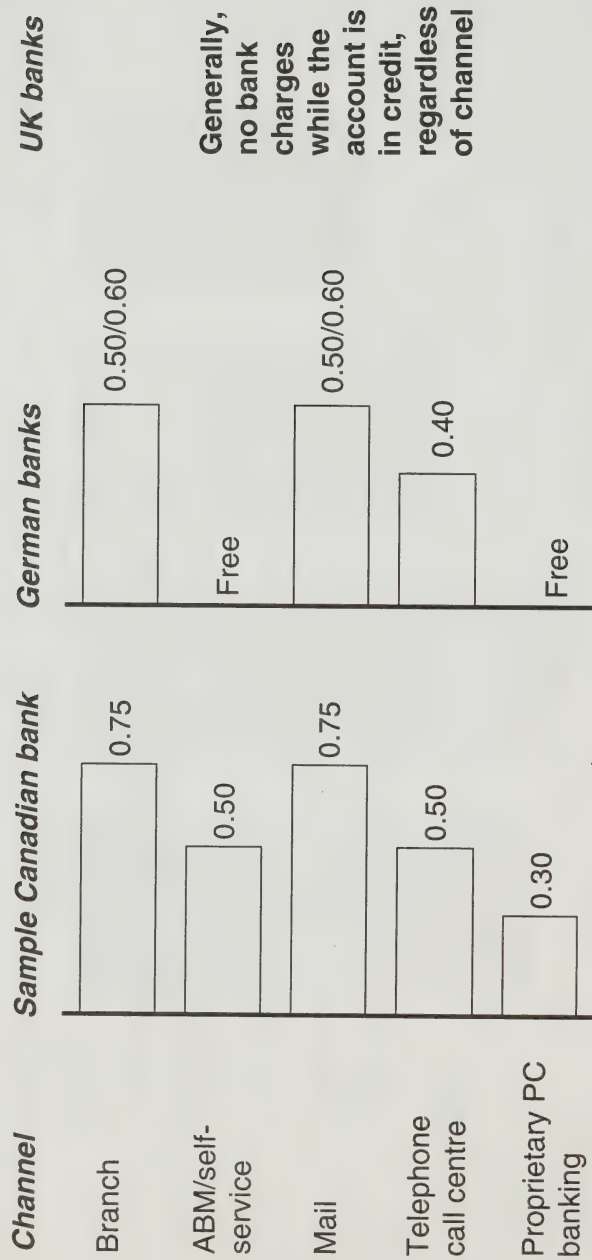


* Based on adaptation of Industry Canada's definition of 8 cheques per month, 6 POS transactions, 5 ABM transactions, and a minimum balance <\$1,000

Source: McKinsey & Company International FI service fee comparison

MONTHLY SERVICE CHARGES ARE GENERALLY HIGHER IN CANADA

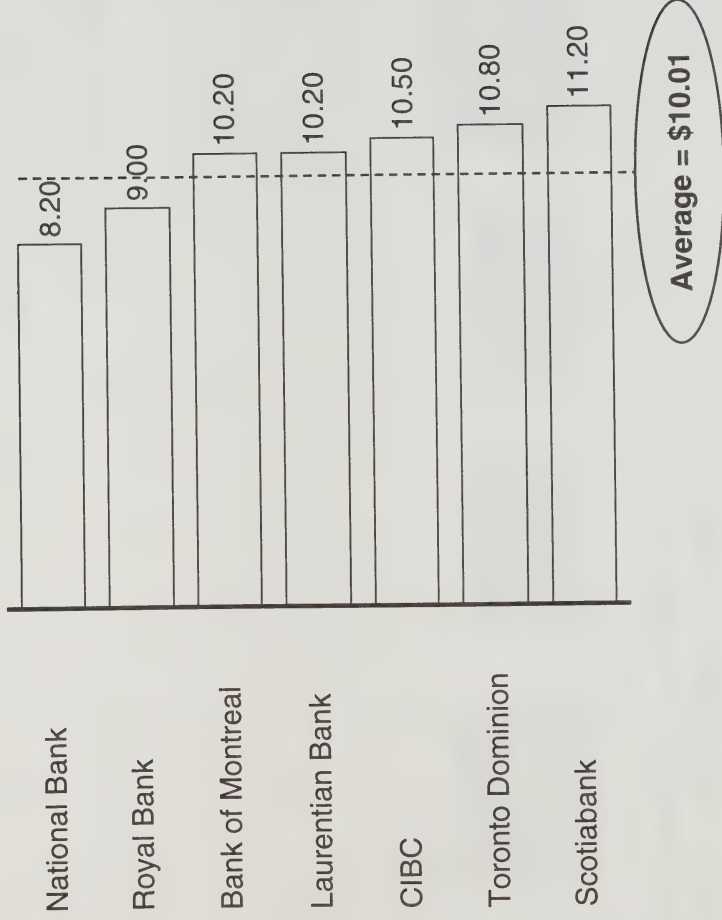
Price differentiation by channel (e.g., bank transfer) 1996
Cdn \$



THERE ARE ALSO DIFFERENCES IN SERVICE CHARGES AMONG CANADIAN BANKS

Average fee on average monthly usage*

Cdn \$

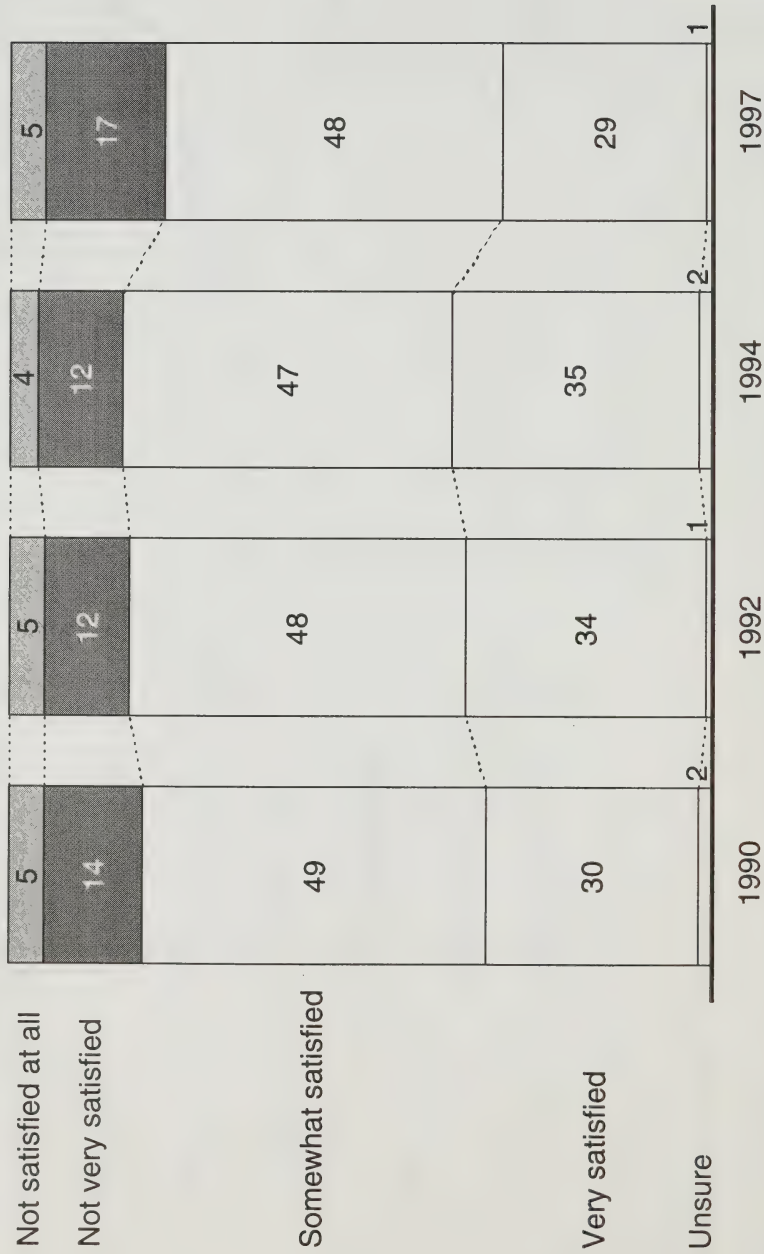


* As defined by Industry Canada (8 cheques/month; 6 POS transactions; 5 ATM transactions; minimum balance <\$1,000)

Source: Industry Canada

ADEQUACY OF INFORMATION IS A PROBLEM

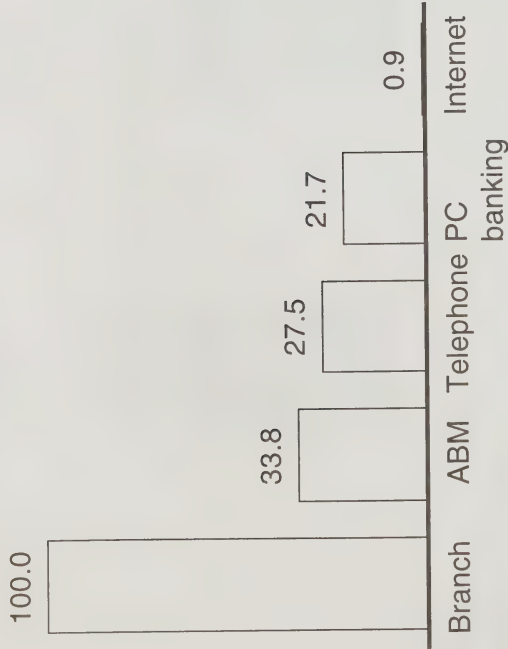
Level of satisfaction with the amount of information provided about service charges by main institution
Percent



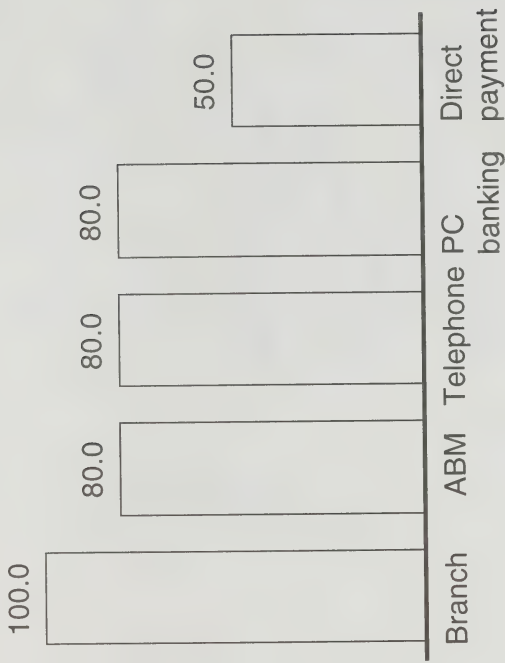
DESPITE LOWER COSTS FOR NEW CHANNELS, CUSTOMERS PAY SIMILAR FEES FOR TRANSACTIONS

NORTH AMERICA

Cost/transaction by channel* 1997
Index



Price/transaction by channel 1997
Index



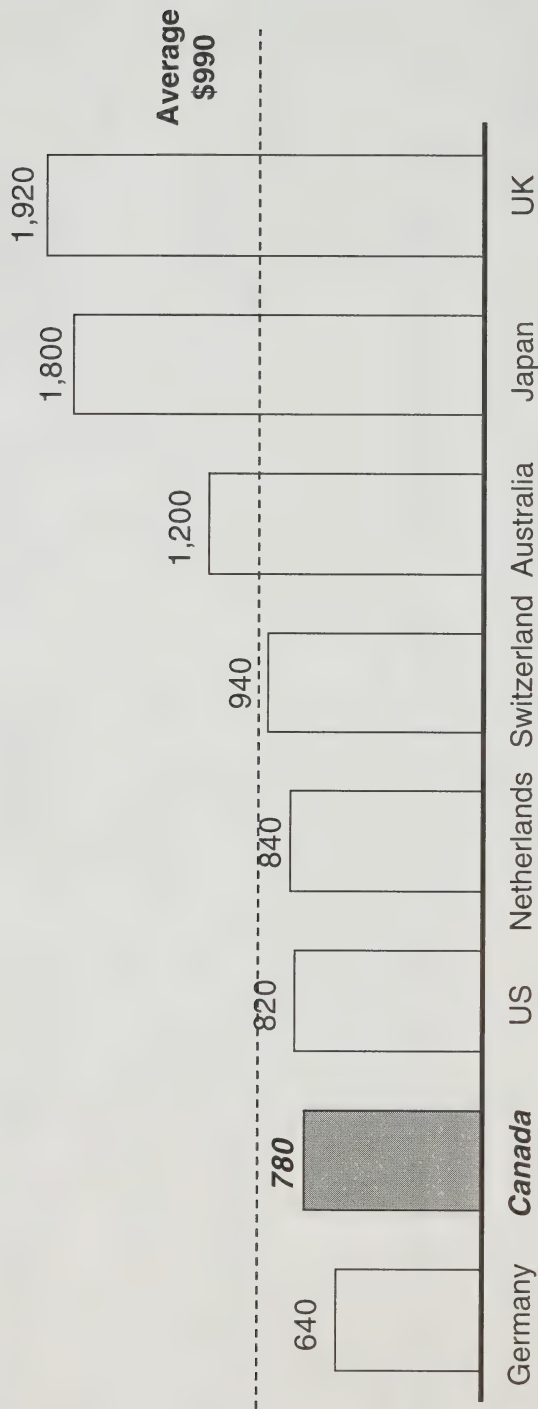
* Costs are for stand-alone networks

Source: Bank Web sites; McKinsey & Company analysis

LIFE INSURANCE PREMIUMS ARE BELOW AVERAGE

Annual premium*

Cdn \$



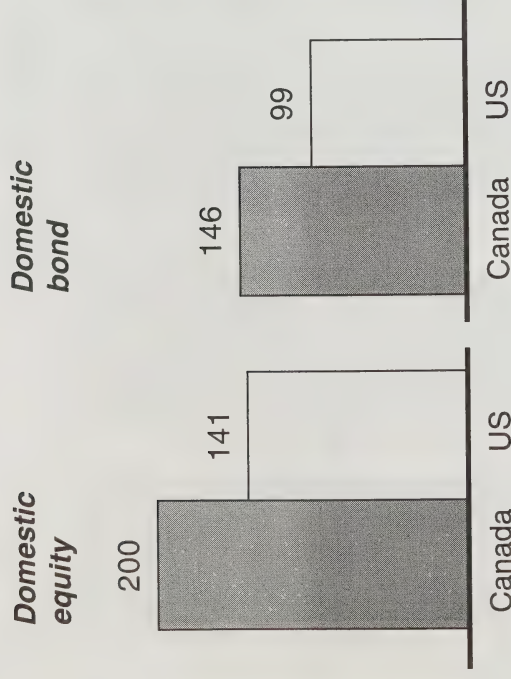
* For a 5-year term policy for a 35- to 45-year-old male, non-smoker insured for \$100,000

Source: McKinsey & Company Global FIG Practice; interviews

MUTUAL FUND FEES ARE HIGHER ON AVERAGE IN CANADA

Canadian vs. US mutual fund expense ratios 1997

Basis points

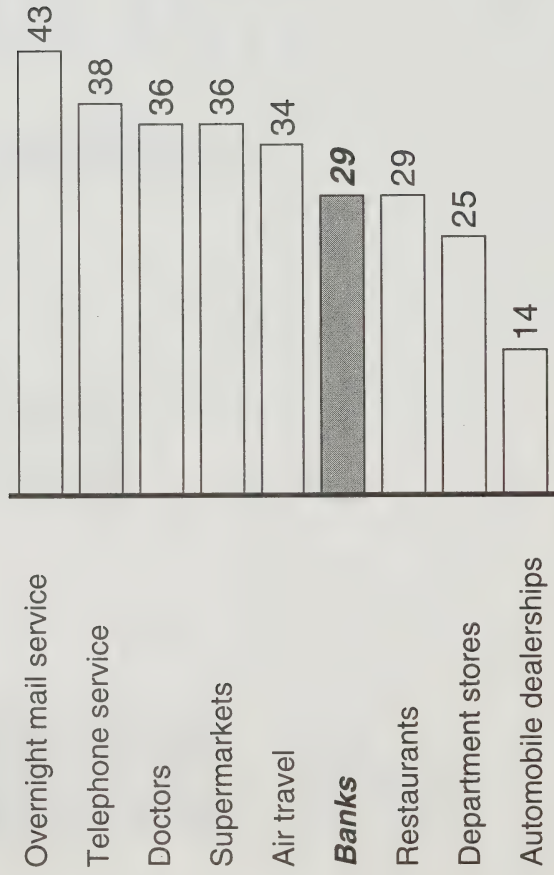


- The higher Canadian fees are due in part to more expensive advice-intensive distribution channels and smaller scale
- Higher fees translate directly into lower returns for customers because they are deducted from the fund's value

BANKING, IN GENERAL, DOES NOT GARNER MUCH ENTHUSIASM ABOUT QUALITY

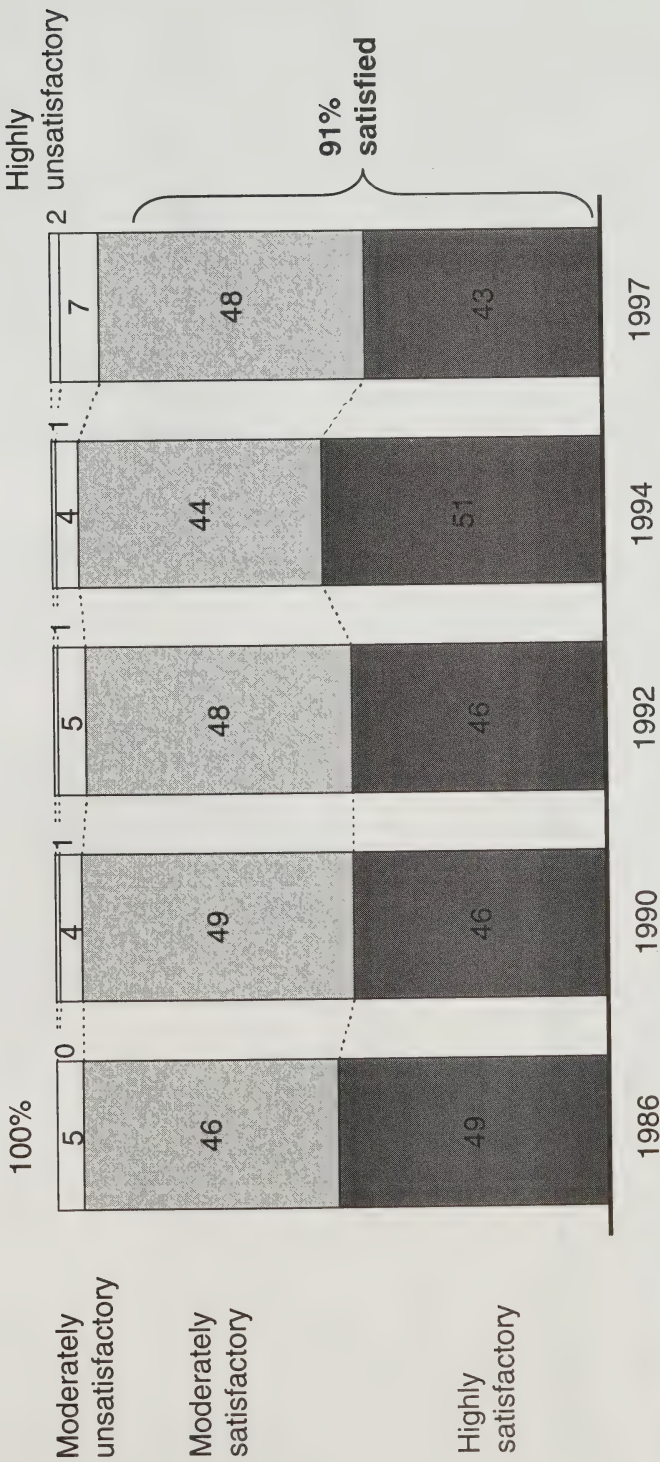
“Based on personal experience, or anything that you may have heard from other sources, the quality of service is excellent/very good”

Percentage agreeing



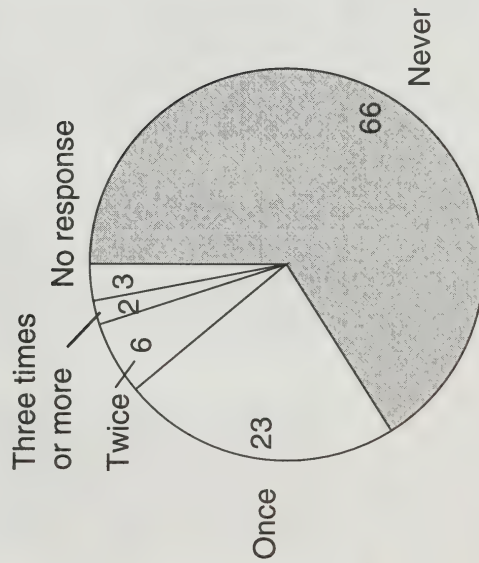
HOWEVER, AMONG BANK USERS, LEVELS ARE GOOD ALTHOUGH PERCENTAGE FOR HIGHLY SATISFIED IS DECREASING

Banks as primary institutions
Percent of respondents



CANADIANS REMAIN LOYAL

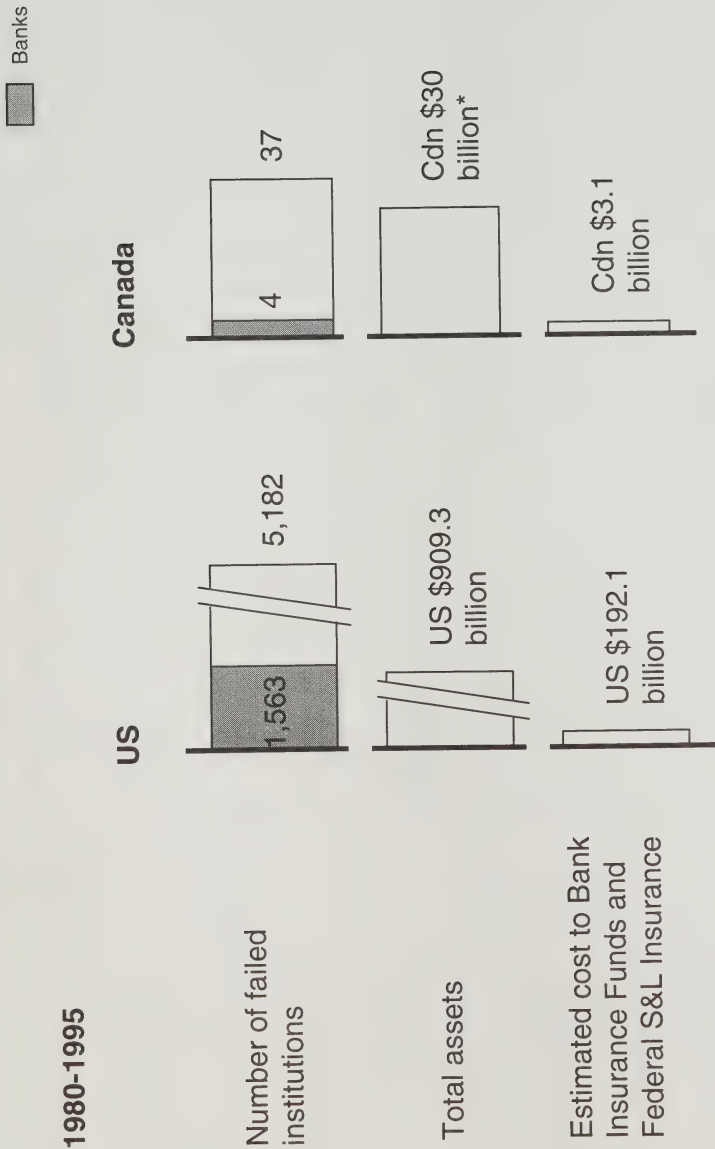
Frequency of switching institutions in the past 5 years



Quality of service
is No. 1 reason for
switching

However, Canadians
may believe there are
no real alternatives

HISTORICALLY, CANADA'S FINANCIAL SERVICES SYSTEM HAS BEEN STABLE



* Estimate of amount of insured deposits

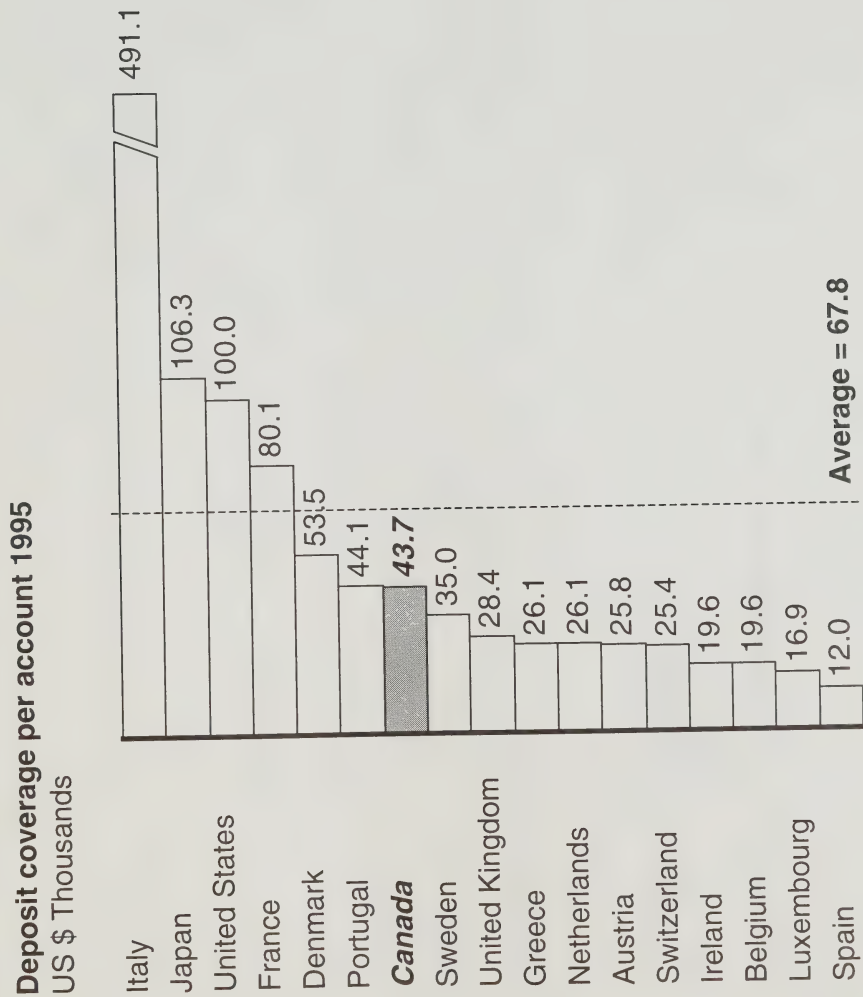
Source: CDIC; US Office of the Comptroller of the Currency, *Commercial Banking Structure, Regulation, and Performance: An International Comparison*, Economics Working Paper 97-6 (March 1997)

CANADIAN BANKS ARE STABLE

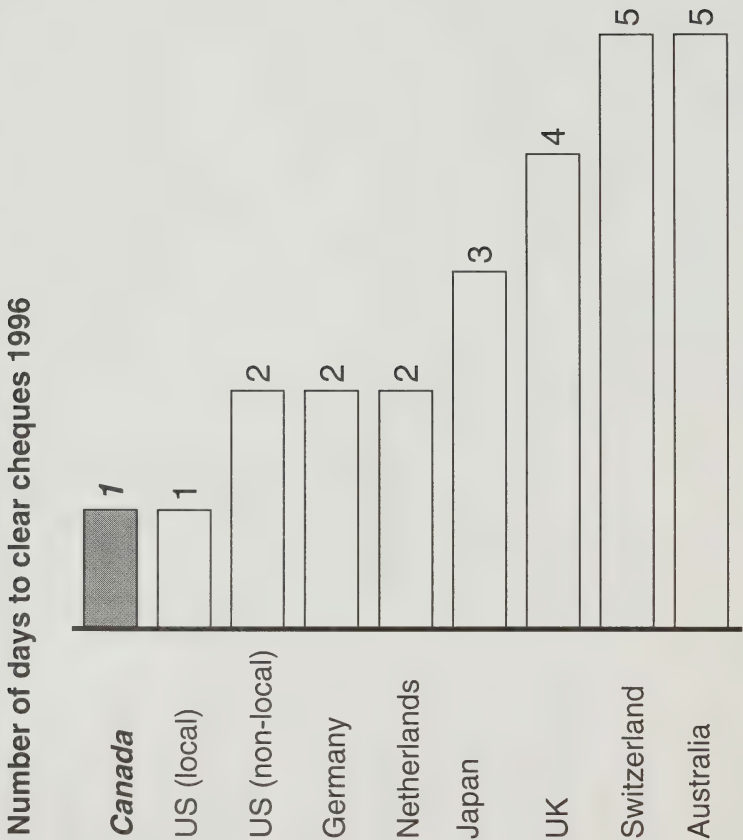
	Number of banks rated	Moody's Investors Service average Financial Strength Rating*
Netherlands	7	B+
Canada	10	B
Switzerland	8	B
Sweden	5	C+
Australia	13	C+
Germany	30	C+
United Kingdom	31	C+
United States	289	C+
Japan	53	D+

* (FSR): Moody's rating of an institution's intrinsic safety and soundness, on a stand-alone basis
Source: *The Banker*, February 15, 1998

CANADA PROVIDES ADEQUATE DEPOSIT INSURANCE COVERAGE



CANADA'S PAYMENT SYSTEM IS EFFICIENT



Source: BIS; J.M. Lacker: *The Check Float Puzzle*; McKinsey analysis

CANADIANS CAN CHOOSE FROM A FULL RANGE OF PRODUCTS

- + Well-developed
- Not-so-well developed

	Payment services	Credit services	Asset accumulation	Protection	Real estate
Traditional products	<ul style="list-style-type: none"> + Deposits + Payments + Travelers cheques 	<ul style="list-style-type: none"> + Credit lines + Auto loans + Credit cards 	<ul style="list-style-type: none"> + Savings + Mutual funds + Investment management + RRSP + Personal trust + Brokerage 	<ul style="list-style-type: none"> + Life insurance + Personal liability protection + Health insurance 	<ul style="list-style-type: none"> + Mortgages + Property insurance
New developments	<ul style="list-style-type: none"> + Debit cards +/- Smart card trials + Online banking + Telephone banking 	<ul style="list-style-type: none"> - Securitization not as well-developed in Canada 	<ul style="list-style-type: none"> - More options and choices in the US 	<ul style="list-style-type: none"> - No major innovations 	<ul style="list-style-type: none"> - Securitization not as well-developed in Canada

CANADIAN FINANCIAL INSTITUTIONS HAVE BEEN PARTICULARLY SUCCESSFUL IN HOME BANKING

Canada Trust's EasyWeb Internet banking service named Best Foreign Bank Online Program by US-based Online Banking Association

Canada Trust

[EasyWeb login](#) | [EasyWeb info](#) | [EasyLine](#) | [ABMs](#) | [Branches](#) | [Rates](#) | [Fund prices](#) | [Stock quotes](#) | [Brokerage](#)

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Top 10
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LYCOS "Best of the Web"

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www.canadatrust.com/index.html

Source: Canada Trust Web site; Financial Service Online Web site.

US-based Web site!

Financial Service **ONLINE**

Top 10 Home Banking Programs in the U.S.

Bank Name	Number of Users
NationsBank	400,000
Wells Fargo	350,000
Citibank	275,000*
BankBoston Corp.	225,000
Bank of America	100,000*
Bank of Montreal	100,000
Chase Manhattan Bank	85,000
Canadian Imperial Bank of Commerce	80,000
Toronto Dominion Bank	75,000
Banc One Corp.	65,000*

*Estimate. Source: 1998 Directory of Home Banking & Online Financial Services.

CANADA HAS AN EXCELLENT DISTRIBUTION NETWORK

Statistics for "Group of Ten Countries"

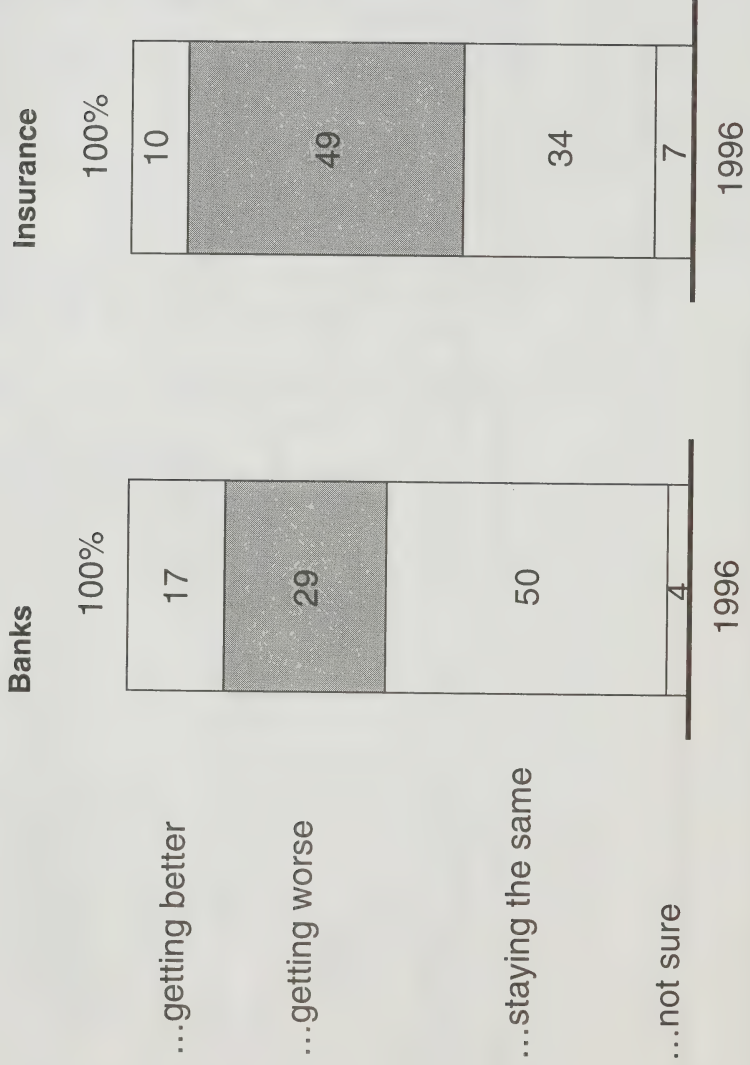
Branch density ranking		ATMs ranking		POS ranking				
Number of branches*/ 10,000 inhabitants 1996		Number of machines/ 10,000 inhabitants 1996		Number of terminals/ 10,000 inhabitants 1996				
1.	Belgium	7.47	1.	Japan	10.51	1.	UK	93.54
2.	Germany	5.73	2.	Canada	6.17	2.	France	93.33
3.	Switzerland	5.07	3.	UK	5.85	3.	Canada	84.08
4.	Sweden	4.19	4.	US	5.24	4.	Belgium	79.97
5.	Italy	3.08	5.	Germany	4.59	5.	Sweden	75.79
6.	Canada	2.72	6.	Italy	4.20	6.	Netherlands	61.86
7.	France	2.49	7.	France	4.19	7.	Switzerland	47.31
8.	US	2.26	8.	Belgium	4.14	8.	Italy	37.58
9.	UK	2.04	9.	UK	3.76	9.	US	32.97
10.	Netherlands	1.64	10.	Netherlands	3.73	10.	Germany	14.02

* Commercial and Savings Bank branches

Source: Statistics on Payment Systems in The Group of Ten Countries, BIS

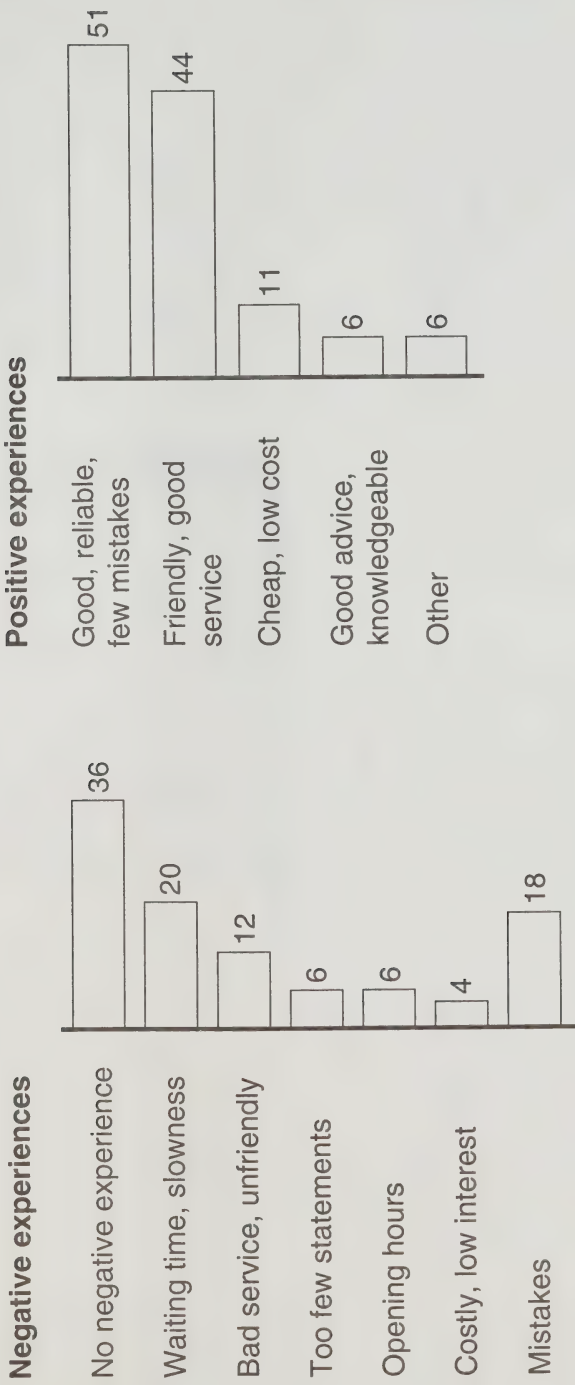
SERVICE IN THE US IS NOT IMPROVING

Percent responding "Service is..."



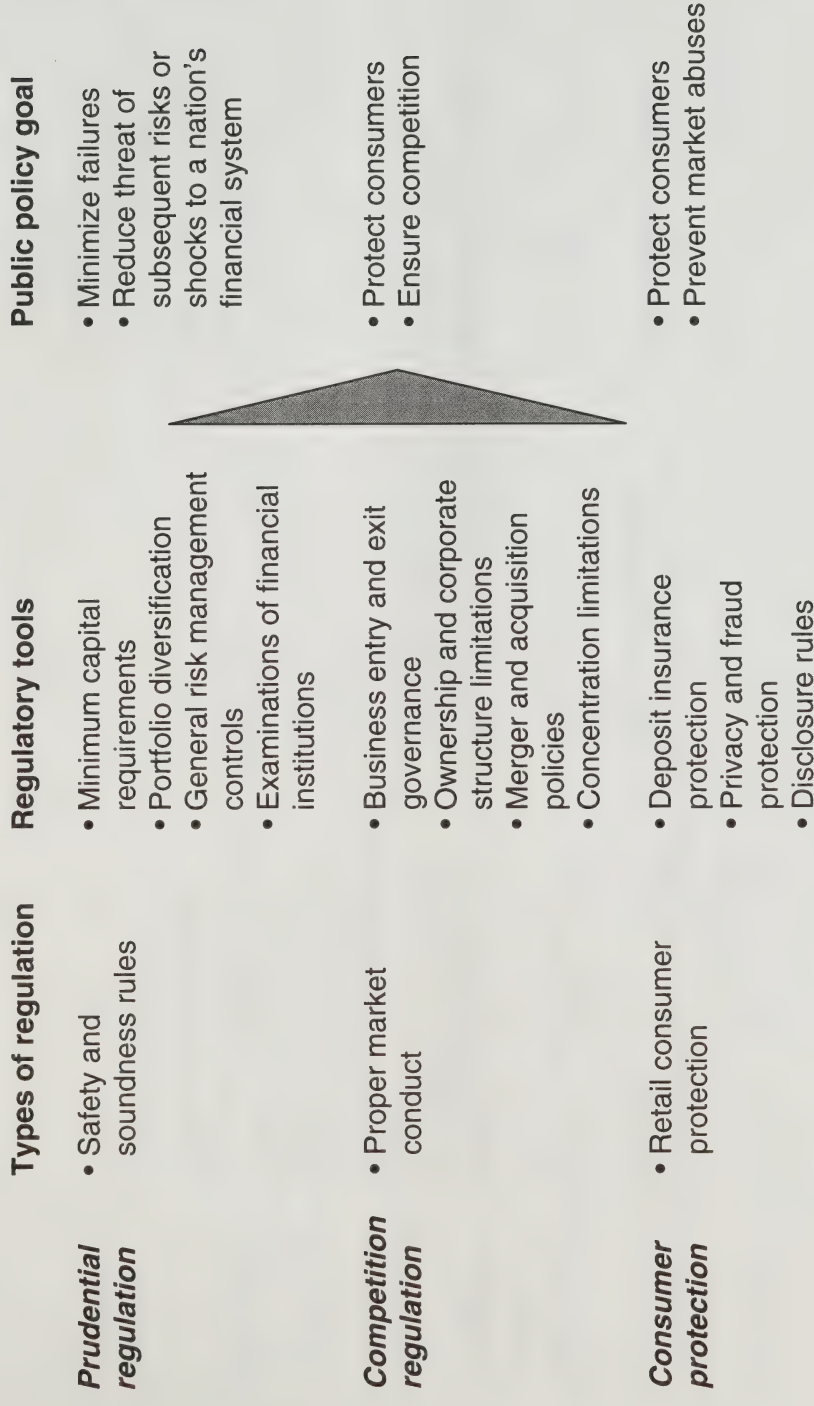
THE NETHERLANDS EXPERIENCES LOW SATISFACTION LEVELS AS WELL

Customer experience of bank service
% of respondents

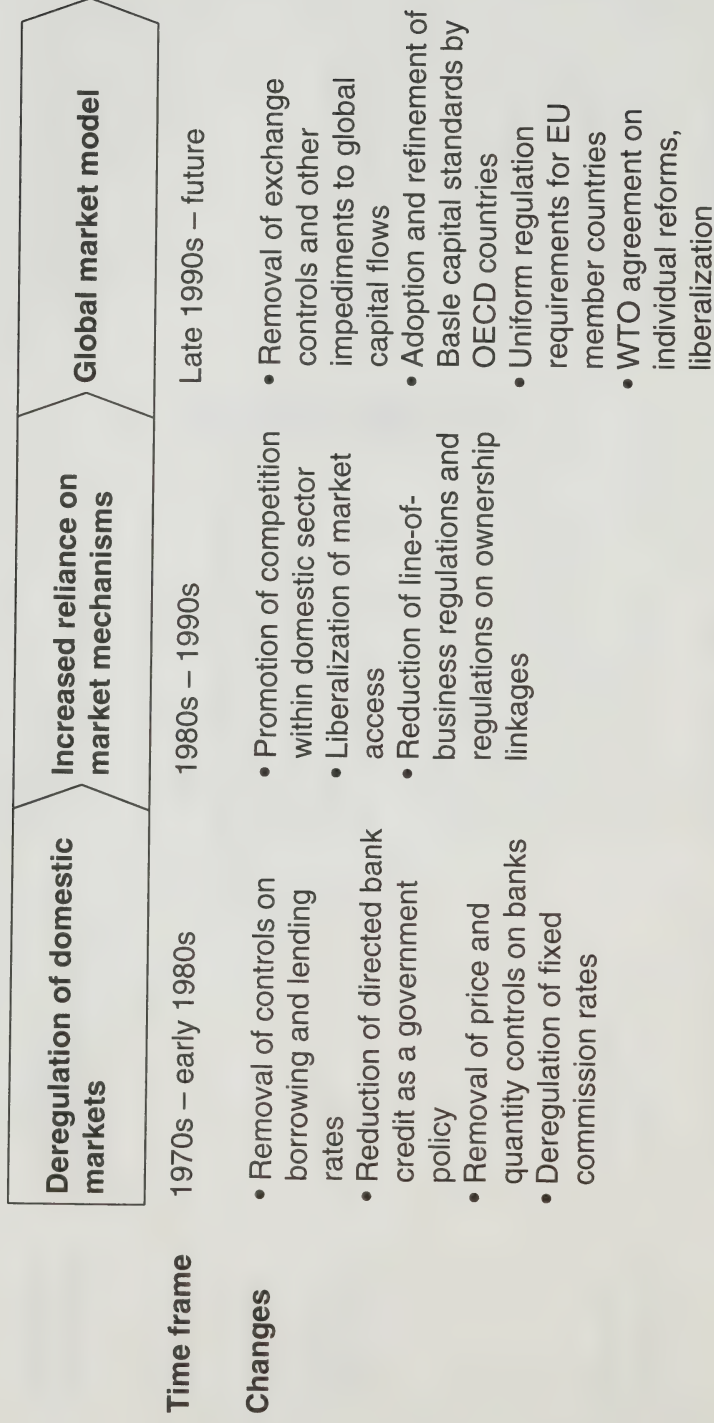


Chapter 7 Exhibits

REGULATION OF FINANCIAL SERVICES CAN BE DIVIDED INTO THREE AREAS



STAGES OF REGULATORY RESPONSE TO MARKET CHANGE



GOVERNMENTS INCREASINGLY FAVOUR GREATER COMPETITION THROUGH LESS REGULATION

PRELIMINARY

- ☐ Abolished, or never existed
☒ Still in place, to some extent
☒ Still in place

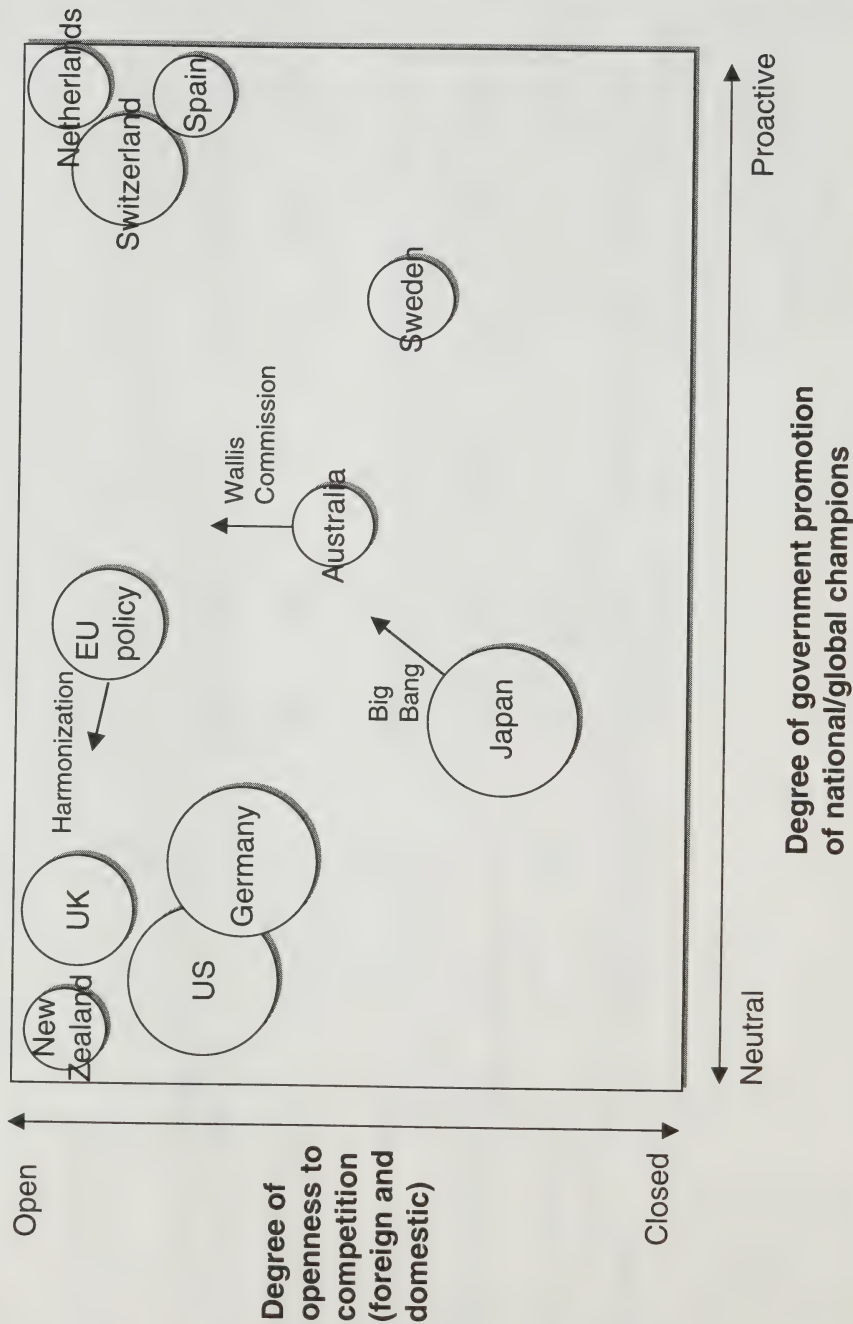
Regulation	Australia*	France	Germany	Nether- lands	New Zealand	Spain	Sweden	Switzer- land	UK	US
Interest rate regulation	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Restrictions on range of domestic activities	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input checked="" type="radio"/>
Restrictions on market access	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Ownership restrictions	<input checked="" type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Restrictions on cross-border financial services	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Restrictions on cross-border capital flows	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

* Post Wallis (excluding taxation-driven negotiations)

Source: OECD; EC; National regulators; interviews; McKinsey analysis

NATIONAL POLICY GOALS DIFFER AMONG COUNTRIES

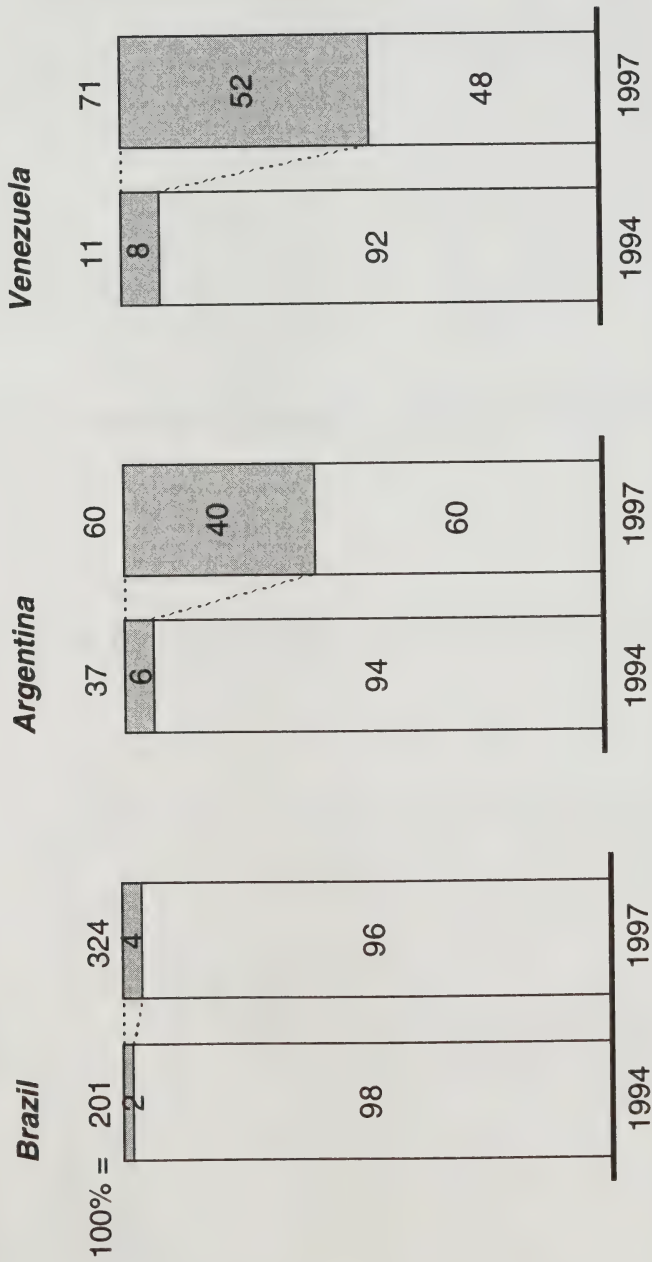
CONCEPTUAL






IMPACT OF OPENING MARKETS MUST BE CONSIDERED



















































Foreign-owned
Domestically-owned

Top 10 banks by assets US \$ Billions



CANADIAN BANKS USE SUBSIDIARIES TO SERVE CUSTOMERS WITH NEW PRODUCTS

 Subsidiary most frequently used
 Direct
 Holding company affiliate

	Securities	Insurance	Real estate
Canada			
Australia			
Austria			
Finland			
Germany			
Greece			
Ireland			
Italy			
Luxembourg			
Netherlands			 
New Zealand			
Portugal	 		
Spain			
Sweden			n/a
Switzerland			
United Kingdom	Varies		Varies
United States	  *	 *	n/a

* Mainly brokerage activities

Source: US Office of the Comptroller of the Currency, *Commercial Banking Structure, Regulation, and Performance: An International Comparison*, Economics Working Paper 97-6 (March 1997)

A VARIETY OF DEPOSIT PROTECTION PLANS EXISTS TODAY WORLDWIDE

☐

 Risk-based premiums

System administration			
Membership	Government	Joint government/ industry	Industry
Compulsory	Canada*	Belgium	Austria
	Denmark	Greece	Finland
	Ireland	Japan	France
	Portugal	Netherlands	Luxembourg
	Sweden	Spain	
Voluntary	United Kingdom		
	United States		
			Germany Italy Switzerland

* Canada is about to introduce risk-based premiums
Source: US Office of the Comptroller of the Currency, *Commercial Banking Structure, Regulation, and Performance: An International Comparison*, Economics Working Paper 97-6 (March 1997)

GLOBAL USE OF BANK HOLDING COMPANY STRUCTURES IS LIMITED

Permitted and widely used	Permitted but not widely used	Not permitted
Italy	Finland	Canada
Netherlands	Germany	Greece*
United States	Ireland	Luxembourg
	Japan	Sweden
	Portugal	
	Spain	
	Switzerland	
	United Kingdom	
	Australia	
	New Zealand**	

* Holding companies may own the majority of shares in a Greek bank, but no specific legal framework refers to such companies

** Not widely used because institutions are mostly foreign-owned

Source: US Office of the Comptroller of the Currency, *Commercial Banking Structure, Regulation, and Performance: An International Comparison*, Economics Working Paper 97-6 (March 1997)

MANY COUNTRIES PERMIT NON-FINANCIAL FIRMS TO OWN COMMERCIAL BANKS

Unrestricted	Permitted with conditions	Restricted
Austria	Australia ⁴	Canada ¹⁰
Finland	Belgium ⁵	Italy ¹¹
France	Denmark ⁶	Japan
Germany ¹	Ireland ⁷	Luxembourg ¹²
Greece	Netherlands ⁸	Sweden ¹³
Portugal	Spain ⁹	United States ¹⁴
Switzerland ²		
United Kingdom ³		
New Zealand		

¹ Based on suitability of shareholder

² Not prohibited, but generally not made

³ Acquirer must pass financial service authority "fit and proper" test

⁴ Acquisition of more than 10% of a bank's voting stock requires regulatory approval; foreign acquisitions require approval of treasurer

⁵ Bank commission examines "fit and proper" character of shareholders holding >5% of bank's capital

⁶ Requires supervisory approval, but such investments generally not made

⁷ Notification is required for 5% of voting rights, prior regulatory approval required for 10% of voting rights

⁸ Declaration of non-objection from Ministry of Finance is required for >5% of bank's capital

⁹ With Bank of Spain approval above 5% share

¹⁰ Limited to 10% of outstanding shares to ensure banks are widely held

¹¹ Restricted to 15% of bank's voting shares, subject to approval by Bank of Italy

¹² Non-financial firms may be majority shareholders of banks, but that is generally discouraged by policy

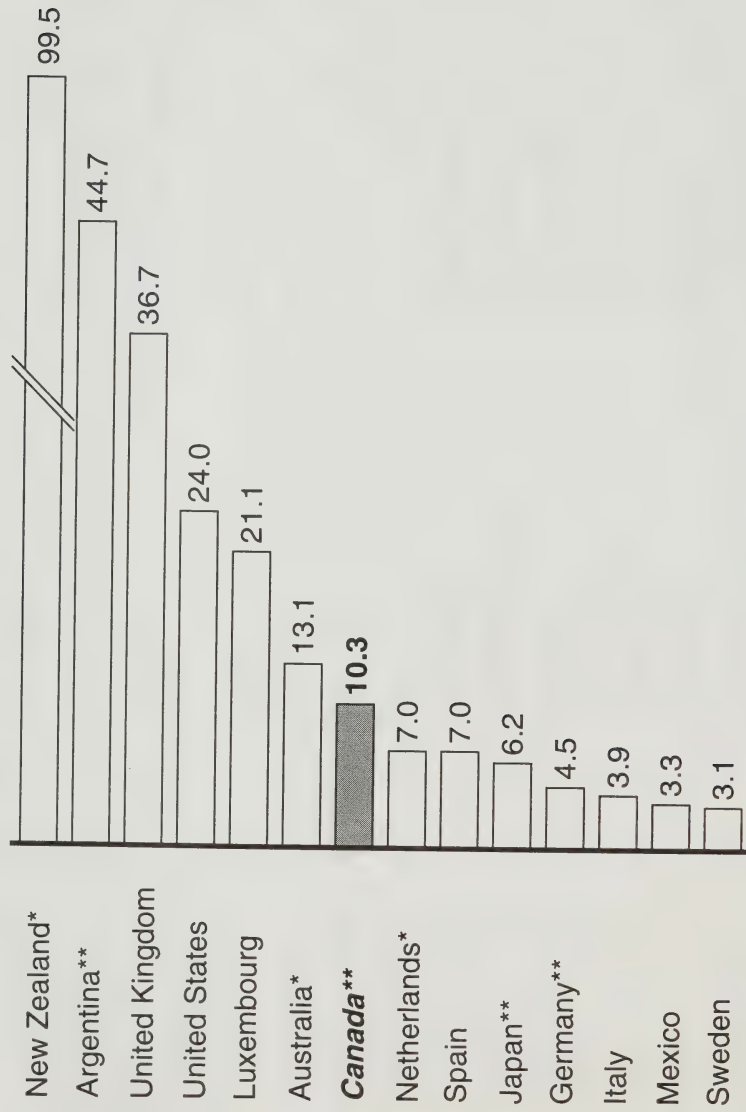
¹³ Ownership is restricted to 50% unless insolvency

¹⁴ Restricted by Bank Holding Act for Commercial Banks, but any company can own a Federal Savings Bank (FSB) which is a retail banking license

Source: Institute of International Bankers, *Global Survey*, 1997

EXTENT OF FOREIGN BANK ENTRY VARIES BY COUNTRY

Foreign bank assets/total domestic assets 1995
Percent

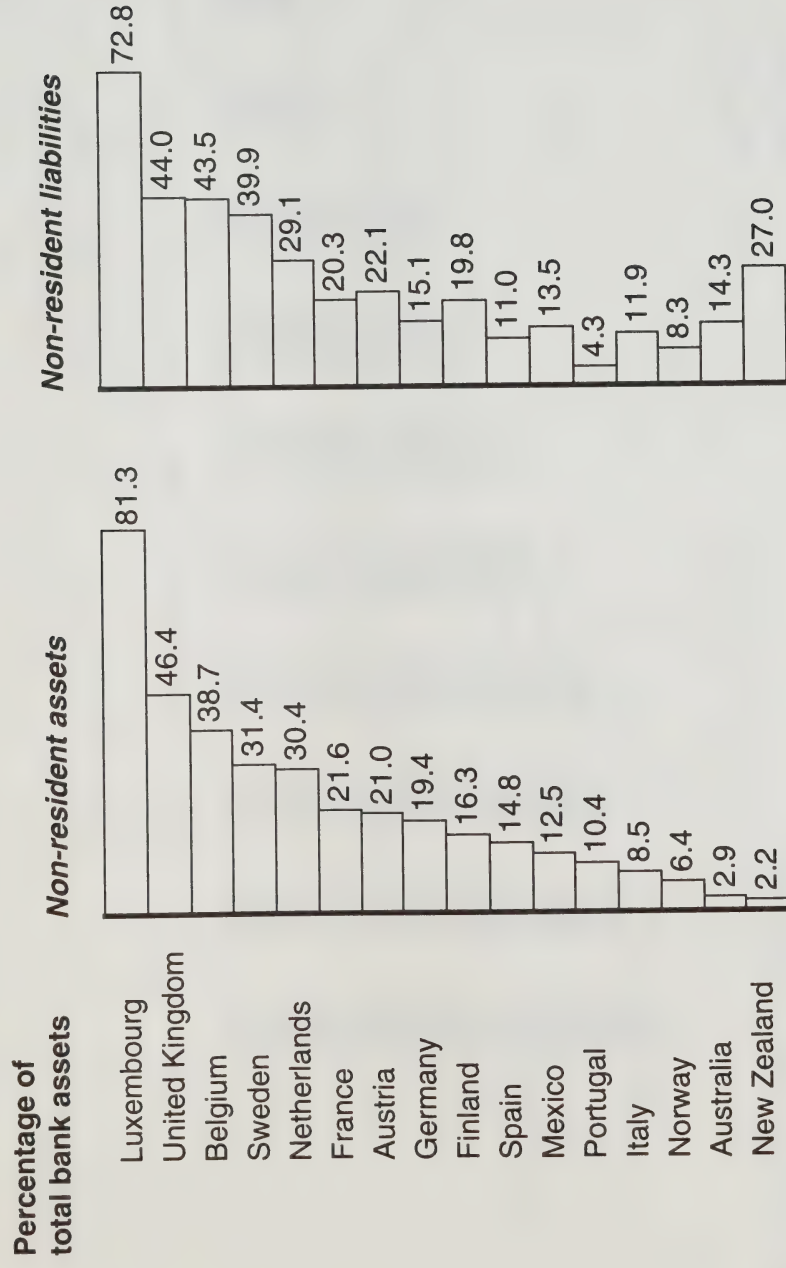


* 1996 data

** 1997 data

Source: OECD, *Banking Profitability*, 1997 ed., 1995 data; McKinsey & Company analysis

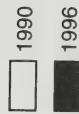
NON-RESIDENT ASSETS VARY BY COUNTRY



BANKING CONCENTRATION IS INCREASING IN MOST COUNTRIES

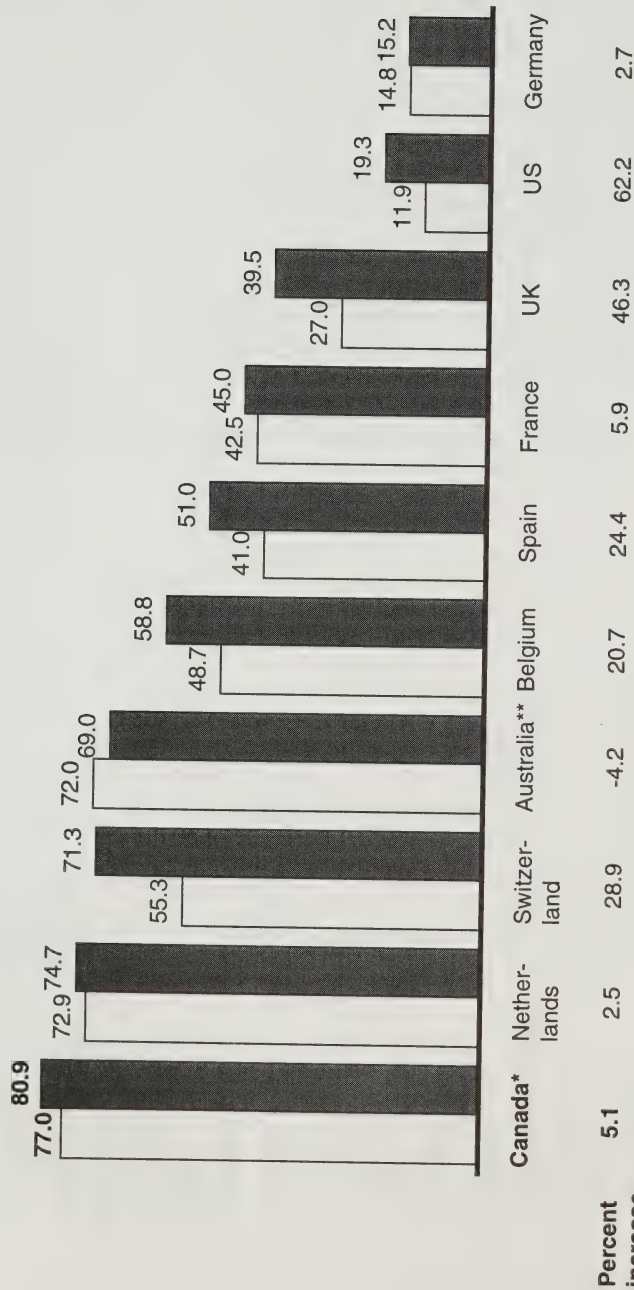
Top 5 banks

Percent of total domestic banking assets



1990 average = 46.3%

1996 average = 52.5%



* Top 6 for Canada equals 83.2% in 1990 and 86.9% in 1996

** Includes effects of transformation of a number of building societies to banks
Source: McKinsey & Company Global FIG Practice; annual reports; OSFI

DEREGULATION IN TELECOMMUNICATIONS HAD A DRAMATIC EFFECT ON INCUMBENTS

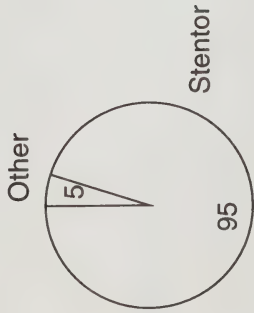
ILLUSTRATIVE

Market share

Canada
Cdn \$ Billions,
percent

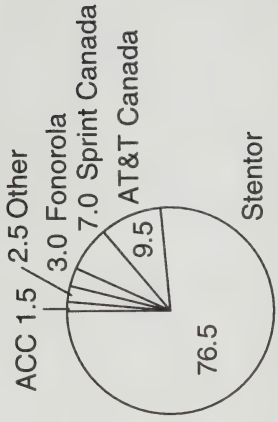
1992

100% = 7.6



1995

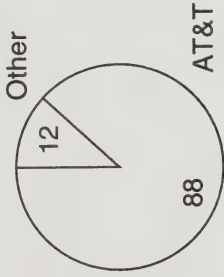
100% = 8.4



United States
US \$ Billions,
percent

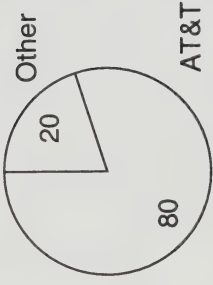
1984

100% = 9.9



1987

100% = 11.4



* Stentor members include BC Tel, AGT, SaskTel, ManitobaTel, Bell Canada, Quebec Tel, Burntor, Newfoundland Tel
Source: James Capel Canada; McKinsey & Company analysis

Supplementary Appendix

GLOSSARY OF BANKING TERMS

Term	Definition
A	<p>Allowance for credit losses</p> <p>An allowance set aside from income to absorb anticipated credit losses. It is decreased by write-offs and by realized losses and increased by new <i>provisions</i> and recoveries. The allowance for credit losses is deducted from the related asset category on the balance sheet.</p>
	<p>Automated banking machines (ABMs)</p> <p>Terminals that allow customers to perform many everyday banking tasks, e.g., deposits, withdrawals, utility payments, and transfers between accounts.</p>
	<p>Bank Act</p> <p>Federal government legislation governing how banks operate in Canada. The Bank Act was first passed in 1871 and has been updated periodically – usually every 10 years. The last revision was completed in 1992.</p>
	<p>Bank for International Settlements (BIS)</p> <p>An international financial institution that promotes the cooperation of central banks, fulfills the function of a central bank's bank, and acts as a clearing and settlement agent. It acts as a forum for discussion of international monetary policy and conducts research into international banking developments.</p>
B	<p>Bank of Canada</p> <p>The central bank that formulates and implements monetary policy. As the federal government's fiscal agent, it also helps carry out the government's borrowing program, provides banking services for the government and other clients, and ensures that the need for bank notes across the country is met.</p>
	<p>Basis point</p> <p>A measurement unit defined as one-hundredth of one percent.</p>
	<p>Canada Deposit Insurance Corporation (CDIC)</p> <p>A Crown corporation that provides deposit insurance against the loss of deposits made with member financial institutions.</p>
	<p>Canadian Bankers Association (CBA)</p> <p>A professional industry association that provides information, research, advocacy, education, and operational support services primarily to the banking industry.</p>
C	

GLOSSARY OF BANKING TERMS Continued

Term	Definition
C Canadian Depository for Securities Limited (CDS)	The association responsible for the automatic processing and clearing of all securities transactions in Canada.
Canadian Payments Association (CPA)	The association, composed of several financial institutions and the Bank of Canada, that operates the national clearing system for financial institution payments.
Chartered banks	Financial institutions regulated under the Bank Act. Chartered banks are designated as Schedule I or Schedule II, depending on their ownership.
Clearing and settlement	The process whereby banks collect or pay out for items drawn on or paid into accounts in their institution. This process enables banks to accept one another's cheques and bank drafts for deposit. The Canadian Payments Association operates Canada's clearing system.
D Deposit insurance	Insurance from the Canada Deposit Insurance Corporation that covers a depositors' funds to a maximum of \$60,000 per depositor, per institution, with some exceptions, in the event of a bank failure.
Domestic	Domestic market defined by political boundaries, e.g. Canada's domestic financial services market.
E Electronic data interchange (EDI)	A process that companies use to exchange business information electronically, virtually eliminating paperwork.
Electronic funds transfer (EFT)	A system that transfers funds through electronic messages instead of by traditional means, such as cash or cheques.
F Financial futures	Future commitments to purchase or deliver securities or money market instruments on a specified future date at a specified price. The contracts are obligations between a bank and the organized exchange upon which the contract is traded.

Term	Definition
G Globalization	A global market that operates across national boundaries as if it were a single market. Prices are established on a global basis and global pricing is often referred to as the law of one price.
I Guaranteed Investment Certificates (GICs)	Certificates issued by financial institutions giving evidence of a deposit made that is for a fixed maturity, in registered form, and on an interest-bearing basis. The interest rate is higher than the best rate for a premium savings account.
L Interac	Canada's largest network of ABMs. It allows cardholders to access their accounts from any ABM on the network regardless of which financial institution owns the machine.
L Local	Local refers to a geographic area, e.g., a branch located in the Vancouver local market.
M Market capitalization	Market value of all common shares outstanding calculated by multiplying the common shares outstanding by the price per share.
M Market to book value	Market value of common equity divided by the book value of common equity.
M Money markets	The part of the capital market where government Treasury bills, commercial paper, bankers' acceptances, GICs, and other short-term obligations are bought and sold.
N Net interest income	The difference between interest income on earning assets and interest expense on interest-bearing liabilities. In the management discussion and analysis of operating performance, this is expressed on a taxable equivalent basis.
N Net interest margin	Net interest income on a taxable equivalent basis as a percentage of average earning assets.

Term	Definition
N Non-accrual loans	Loans on which interest is not being accrued because of the existence of reasonable doubt as to the ultimate collectibility of principal or interest, or where a payment is past due more than a prescribed number of days. When interest is received on a non-accrual loan, it may be recorded as income only if there is no specific provision for loss against that loan.
O Office of the Superintendent of Financial Institutions (OSFI)	Institution created by the Financial Institutions and Deposit Insurance Amendments Act, that regulates banks and other federally incorporated financial institutions in Canada.
P Prime rate/prime lending rate	A variable per annum rate of interest (announced and adjusted by the banks from time to time) that banks charge their most creditworthy business customers on short-term loans. It is also used as a guide for setting the rates for other customers.
Productivity (NIX) ratio	The efficiency with which expenses are incurred to generate revenue. It is non-interest expenses as a percentage of the sum of net interest income and other income.
Provision for credit losses	The provision, which is a charge to income that is the amount added to the allowance for credit losses to bring it to a level that management considers adequate to absorb all credit-related losses in its portfolio (see allowance for credit losses for balance sheet effects).
Regional	Regional refers to a specific region such as North America or inter-state such as the Northwest US.
Return on assets	Net income as a percentage of average total assets. A key profitability ratio indicating how effectively a bank has used its total resources.

R

R

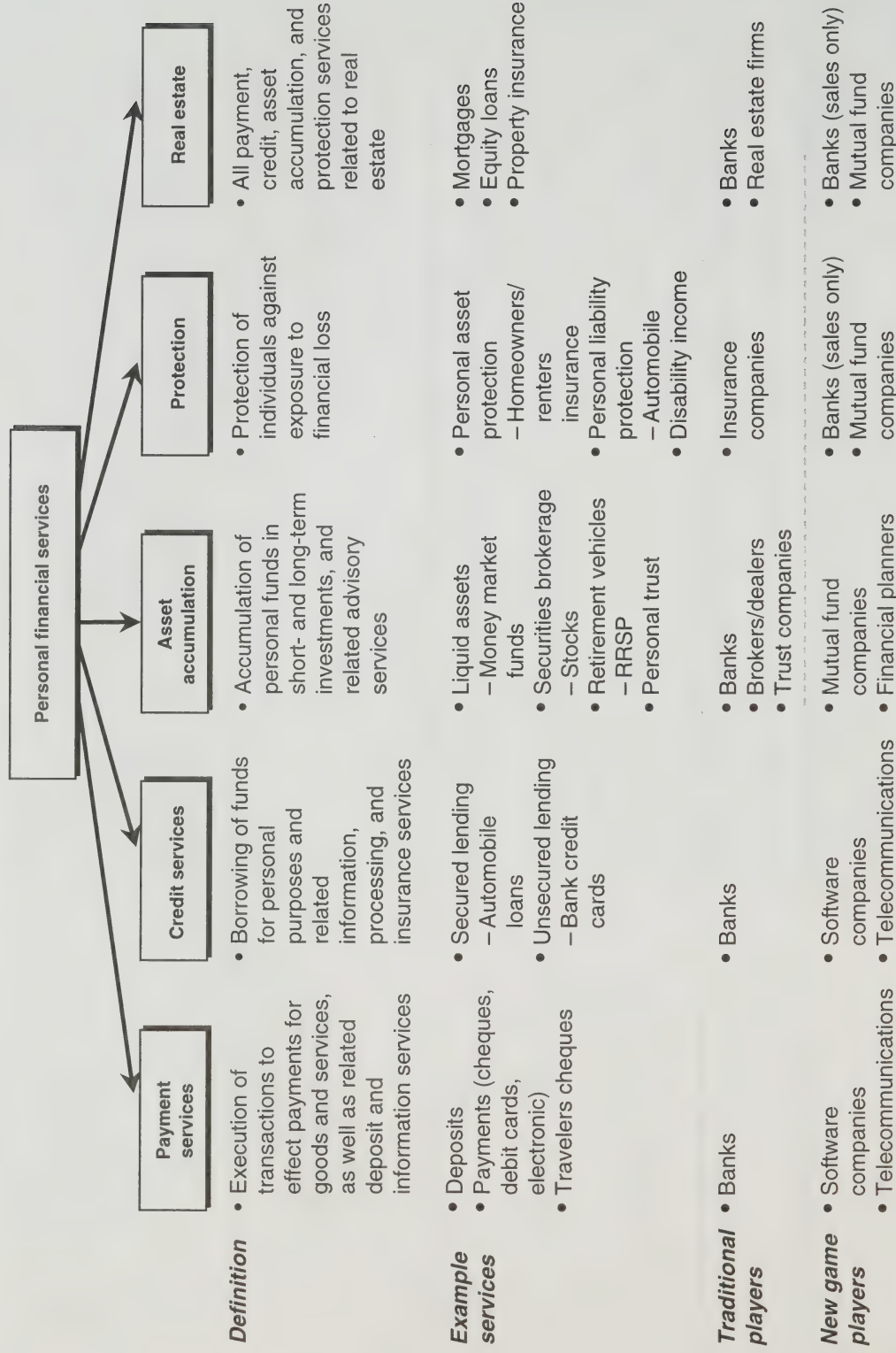
Term	Definition
Risk-adjusted (BIS) capital	Tier 1 (core) and tier 2 (supplementary) capital as defined by OSFI under the Bank for International Settlements (BIS) framework. Tier 1 capital is common shareholders' equity plus qualifying non-cumulative perpetual preferred shares. Tier 2 capital includes subordinated debt and other preferred shares, less investments in associated corporations and amortization of subordinated notes.
Risk-based (BIS) capital ratios	Risk-adjusted capital as a percentage of risk-weighted assets. OSFI requires a total capital ratio of at least 8% and a tier 1 capital ratio of at least 4%.
Risk-weighted assets	Determined by applying an appropriate risk-weight factor to the face amount of each asset and the notional principal amount of each off-balance sheet contract. The risk-weight factors are established by the OSFI to convert assets and off-balance sheet contracts to a comparable risk level.
Schedule I banks	A designation in the Bank Act that refers to Canadian-owned banks that are widely held – i.e., ones in which no one owner holds more than 10% of shares.
Schedule II banks	A designation in the Bank Act that refers to foreign-owned banks and closely held Canadian banks – i.e., banks in which an owner may hold more than 10% of outstanding stock.
Securitization	The process of converting loans, such as mortgages and credit card balances, into securities thereby removing the asset from the intermediary's balance sheet.
Spread	The difference between the interest rate paid on depositors' funds and the interest rate charged to borrowers.
Syndication loans	Loans to a company backed by a group of banks in order to share the risk in a large transaction among several financial institutions. There is usually a lead bank and several participating banks.

S

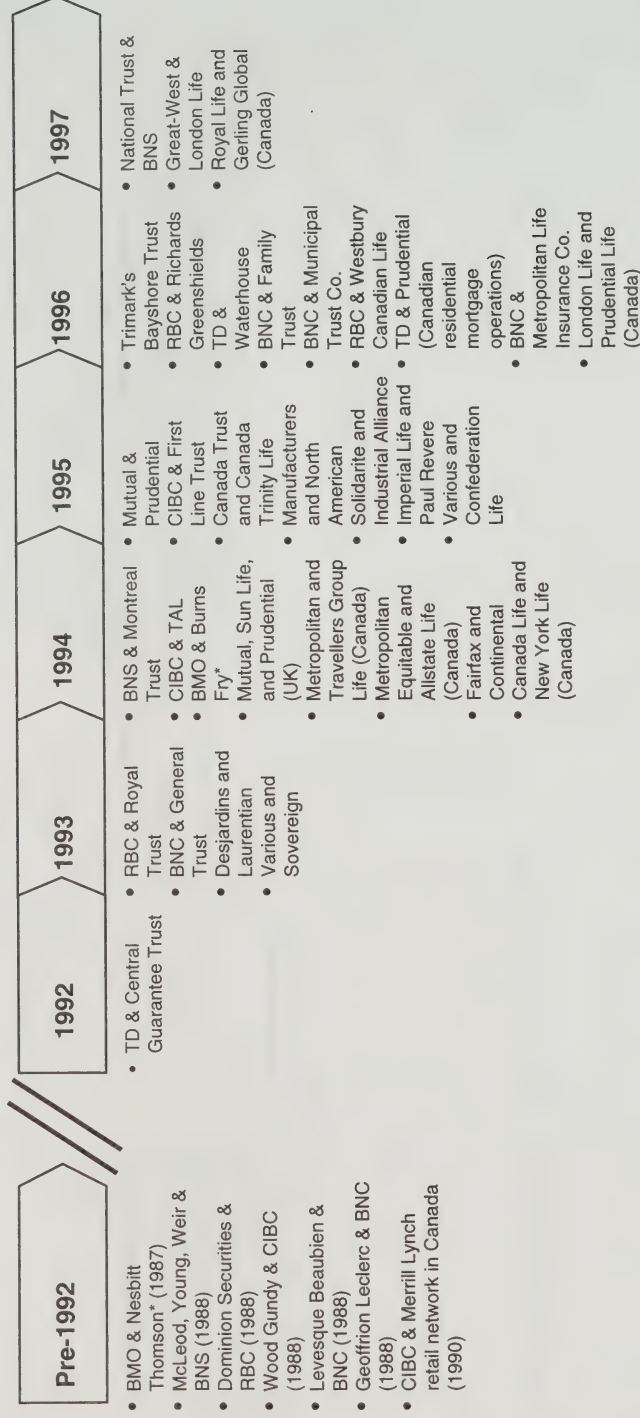
T

Term	Definition
Tier 1 capital	Capital consisting of common equity (share capital and retained earnings), non-cumulative preferred shares and non-controlling equity interest in subsidiaries, net of goodwill. Tier 1 capital is used for calculating regulatory compliance ratios.
Tier 2 capital	Capital consisting of subordinated indebtedness (perpetual and other debentures) and cumulative preferred shares.

OVERVIEW OF PERSONAL FINANCIAL SERVICES

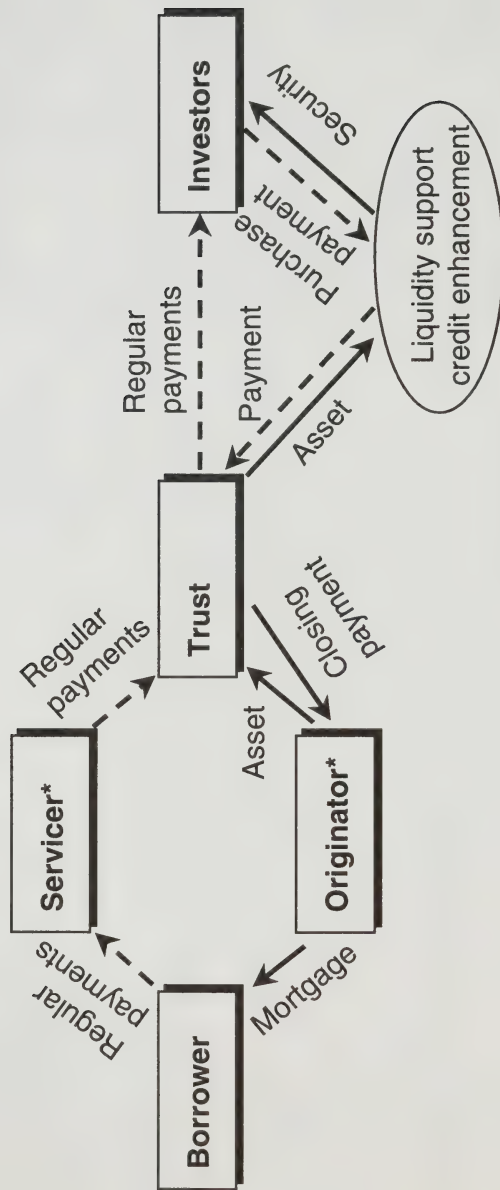


SELECT MERGERS AND ACQUISITIONS



* Renamed Nesbitt Burns in 1994

OVERVIEW OF SECURITIZATION CASH FLOW



* Originator-servicer may be the same institution
Source: Canada Trust; McKinsey & Company analysis

